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ABSTRACT

Fiscal stress has plagued state and local governments in the first part of the 1990s, and difficulties in balancing budgets and obtaining revenue for needed public services are likely to continue. This document examines the leading alternatives for increasing state and local tax revenue, pointing out that the best options vary from state to state. It is concluded that the state government should play a major role in funding schools, but a strong case can also be made for relying on local school districts to raise a significant portion of their own revenues. The personal income tax has become more prominent in state tax systems; however, the property tax is still the primary source of local school revenue. Taxes differ in their growth potential, fairness, economic effects, stability, ease of administration, political salability, and exportability. Nine options for increasing state tax revenues are identified. The real root of financial inequality among districts is the reliance on local revenue, not the property tax itself. Suggestions for when and how to raise taxes, which is not always a political liability, are offered. State and local tax systems vary greatly. The benefits of earmarking taxes and lotteries for education are often exaggerated. The most attractive revenue opportunities for each state are concentrated in the three major taxes--personal income, sales, and property. Ten tables, one figure, and a glossary are included. (LMI)

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TAX OPTIONS FOR STATES NEEDING MORE SCHOOL REVENUE

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Steven D. Gold
Center for the Study of the States

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Executive Summary

Fiscal stress has plagued state and local governments in the first part of the 1990s, and difficulties in balancing budgets and obtaining revenue for needed public services are likely to continue. With sharply rising spending for health and corrections programs, federal mandates, rising school enrollments, and outmoded tax structures, states will have to raise taxes and strengthen their tax systems if education is to meet the challenges of the 21st century.

This book examines the leading alternatives for increasing state and local tax revenue. It recognizes that the best options vary from state to state and that the advantages of each tax must be weighed against its disadvantages.

State or Local Revenue

State government should play a major role in funding schools because it has the power to even out resources between rich and poor areas, because it is in a much better position to employ sales and income taxes than are local governments, and because many of the benefits of education spill out beyond the boundaries of local school districts. But a strong case can also be made for relying on local school districts to raise a significant proportion of their own revenue.

Money Sources

State and local taxes claim about the same proportion of personal income as they did in 1970, but some important changes have taken place in state tax systems. Most importantly, the personal income tax has become more prominent, so that it now raises nearly as much revenue as the state sales tax. Business and excise taxes play a much smaller role than they did previously.

The property tax is still the primary source of local school revenue. Independent school districts rely on sales and income taxes in only a few states.

A Framework for Comparisons

Proposals to increase revenue should take account of important differences in the characteristics of various taxes. All taxes are not the same. They differ, for example, in their growth potential, fairness, economic effects, stability, ease of administration, political salability, and exportability.

The higher a tax's rate, the more glaring its imperfections. Therefore, it is desirable to have a relatively balanced tax system that makes substantial use of taxes on personal income, sales, property, businesses, and other common tax bases. It is also desirable to avoid exemptions, that is, to have a broad tax base.

All taxes have shortcomings. Often these defects can be mitigated or offset by developing a package of tax modifications rather than changing one tax by itself. For example, an increase of a regressive tax can be accompanied by progressive changes in another tax, so that the combined effect is not regressive on balance.

State Tax Options

Nine options for increasing state tax revenue are increasing personal income tax rates, broadening the base of the personal income tax, reducing indexation of the income tax, increasing the sales tax rate, broadening the base of the sales tax, increasing business taxes, increasing excise taxes, imposing a state property tax (or increasing its rate), and expanding lotteries and other forms of gambling.

While all of these options have some potential, they are not of equal importance. If a state needs substantial revenue that will grow significantly over time, the sales and income taxes are usually the best choices. Excise taxes, business taxes, and gambling have limited potential. A state property tax can raise a great deal of money, but it is rarely an attractive choice because the property tax is such an important local revenue source for schools

and because the property tax is even less politically popular than other taxes.

Increasing the personal income tax has several advantages that no other option combines: It is progressive, its revenue grows faster than the economy, and it is deductible for those who itemize federal income taxes.

There are two ways that considerable revenue can often be raised without a large increase in tax rates for families with average income: (1) eliminating sales or income tax deductions and (2) increasing income tax rates at high income levels. Each state's options vary depending on the nature of its existing tax system.

Increasing the degree to which the sales tax applies to services is a critical issue in most states. Because the service sector is the most dynamic part of the economy, tax revenue growth will lag if states continue to exempt most services. Although a few states have broad taxation of services and all states tax at least some services, most states tax services lightly.

Most economists draw an important distinction between taxes on consumer and business services. Taxing consumer services (such as appliance repairs, telephone service, and cable television) treats them the same as consumer goods; there is no economic reason for taxing consumer services more favorably than goods.

Business services are a different matter. Businesses often shift the burden of taxes to consumers. If they are not passed along, the taxes tend to hurt the competitiveness of industries. It is foolhardy for a state to tax businesses that are highly mobile because they can move to another state to avoid the tax. But this is not as much of a problem for services that require close proximity of customers and providers.

Local Tax Options

To a great extent, the property tax is *the* local tax for schools. Many people criticize heavy reliance on the local property tax because it is often associated with big inequalities of resources among school districts. But the real root of inequality is reliance on *local revenue*, not the property tax itself. Disparities would generally be even worse if the local income or sales tax were used instead of the property tax.

Politics

Raising taxes is normally a political liability, but it is not necessarily as politically risky as conventional wisdom suggests. In fact, there was relatively little political fallout from the widespread tax increases enacted by states in 1991 and 1992. To avoid negative political repercussions, state officials must make a strong case that the increase is needed and that the money will be used effectively to maintain or improve services. Tax increases are also more acceptable if they occur gradually rather than in big jumps.

Timing is important. Large tax increases are more feasible in years following elections for the legislature and governor and during periods of state fiscal crisis, particularly during or shortly after recessions.

Important tradeoffs often exist between political feasibility based on public attitudes about taxes and the principles of good tax policy. The taxes that are easiest to increase often have limited revenue potential or have other undesirable characteristics.

How Systems Differ

Tremendous differences exist among state and local tax systems. These differences are one reason why the relative importance of various options for increasing taxes differs among states. As a general rule, states should give strong consideration to raising a tax for which they are below average; the more below average, the stronger the case for raising it. This is especially true if the low tax is the personal income tax, because raising it has several other advantages.

Earmarking

Earmarking of taxes and lotteries for education is widespread. Despite its superficial appeal for education advocates, the benefits of earmarking for education are often exaggerated. State budgeters normally take earmarked revenue into account when they appropriate general state funds, so education does not benefit by the full amount of the revenue earmarked. However, if earmarking increases the political feasibility of raising taxes or authorizing a new form of gambling, it increases total state resources, and schools normally benefit along with other recipients of state funds.

Opportunities

The most attractive revenue opportunities for each state are concentrated in the three major taxes—personal income, sales, and property taxes. Although many themes are common across a broad range of states, the agenda for increasing revenues must be customized. In some states, the best option may be to increase personal income tax rates; elsewhere, it may be to increase the rate of the sales tax; in many cases, broadening the sales or income tax base has considerable potential; and raising the property tax deserves strong consideration in some states.

Chapter 1
What This Book Is About

Fiscal stress has plagued state and local governments in the first part of the 1990s, and difficulties in balancing budgets and obtaining revenue for needed public services are likely to continue. With sharply rising spending for health and corrections programs, federal mandates, rising school enrollments, and outmoded tax structures, states will have to raise taxes and strengthen their tax systems if education is to meet the challenges of the 21st century.

Increasing Revenues

The question is: *From what sources should this money come?* There are many choices. The first decision is how much should come from the state and how much from local schools. If from the state, should it come from the income tax, the sales tax, or some other taxes? Is gambling revenue a viable option? Should it come from raising rates or removing exemptions? At the local level, should it come from the property tax or other taxes? Is it better to reform the tax system or just to rely more heavily on the taxes that are currently being used?

Four general themes run throughout the pages that follow:

1. *The answers to the questions posed above are not the same in all states.* In part, they depend on differences in state economies and value judgments such as how much control should be maintained at the local level. The answers also depend on where a state is starting from: What are the strengths and weaknesses of its existing tax system?

2. *Every tax has strong and weak points.* Sometimes the disadvantages can be minimized by carefully designing the tax or by combining it with other taxes that compensate for its drawbacks.

3. *Good tax policy matters.* It is tempting to be opportunistic and short-sighted, using whatever revenue source seems capable of producing enough money to reach a certain goal in the first year or two after the tax increase goes into effect. But that can often lead to long-run problems that undermine the school finance system (or the state's economy, which feeds back into the way schools are financed).

4. *Good tax policy is often not politically easy.* But many states have succeeded in enacting major improvements in their tax systems. Political skill and courage can help to overcome the obstacles.

Other Options

Despite the premise of this book that states should face up to the need for tax increases, it should not be assumed that more revenue is the entire solution for state fiscal problems. If tax increases are going to be politically acceptable, states must also make hard choices about spending, cutting out low priority programs and increasing the efficiency, effectiveness, and accountability of programs. Spending is, however, outside the domain of this book.

An option not covered in detail in this book is increasing school revenue by shifting resources from other state programs. This could be done, for example, by increasing tuition at state institutions of higher education and thereby allowing the state to reduce its appropriations of tax dollars for those institutions. Or taxes could be increased on health care providers to fund health programs. Reliance on such earmarked taxes can enable states to cut back the additional general fund dollars that are needed for Medicaid and other health programs.

Federal policy is also not explored here. A strong case can be made for the federal government to play a major role in equalizing resources between rich and poor communities. But we assume that no major help is forthcoming from Washington in the foreseeable future.

that it is up to state and local governments to solve their own revenue problems.

In a book of this length, it is not possible to discuss every potential revenue source. The emphasis here is on the options capable of producing large increases in school revenue over time. One of the options that is not discussed is increasing fees and charges. If states boosted user charges for other services, the share of general tax revenue that could be devoted to schools would be increased. Local school districts also may be able to generate more money from fees, not only from conventional sources (like sports and music programs) but also from new initiatives like after-school or weekend foreign language courses for adults. While it often makes sense for states or school districts to consider expanding their use of fees and charges, this option will not be covered in this book.

This book attempts to compromise between two approaches to writing about taxes. One approach is highly technical and scholarly, the other is uncomplicated and straightforward. The first places severe limitations on readership, while the second runs the risk of oversimplification. This compromise draws upon the scholarly research, but it attempts to focus on the principal considerations. As a help to the reader, a glossary of the principal technical terms used in the text is provided.

Chapter 2
The Choice between State and Local Revenue

School revenue was $234 billion in the 1991-92 school year. Nearly half came from states. Slightly less was from local sources. The federal government provided about 7 percent.

Except in Hawaii, where the state operates the public schools, responsibility for raising revenue is shared between the state and local school districts. The state share varies greatly. Not counting federal aid, the state share ranges from 84.8 percent in New Mexico to 8.4 percent in New Hampshire. Table 1 shows the proportion of non-federal school revenue provided by each state government.

A major state role is important for three reasons:

- Only the state can equalize resources between rich and poor areas. If all revenue were local, there would be huge disparities between the resources available in affluent and in low income areas.
- The state is in a better position to impose substantial income and sales taxes, for reasons explained below. It is difficult, if not impossible, to have a well-funded educational system without those taxes.
- Many of the benefits of education spill out beyond the boundaries of the local school district. Such external benefits (for example, more informed citizens, less crime, more taxes paid because of higher earning ability) provide an important rationale for state support.

On the other hand, a strong case can be made for relying on local governments to raise a significant proportion of their own revenue. It helps to preserve accountability. If, as is widely believed, a significant degree of local control is desirable, locally raised revenue is also called for.

The idea that local control and raising taxes locally are linked depends on the assumption expressed in the saying, "He who pays the piper calls the tune." According to this view, if localities do not generate much of their own revenue, they are likely to be completely under the thumb of state policymakers.

This assumption can be questioned on two accounts. First, local revenue is no guarantee of local autonomy. The state government may be able to use its power to mandate how much localities can spend and how they spend it, even if much of their revenue is raised locally. On the other hand, it is theoretically possible for a state to raise money and then turn it over to local schools with few strings attached. So the connection between local revenue and local control is not ironclad. Nevertheless, other things being equal, it is conducive to local autonomy if a substantial share of school revenue is raised locally.

Locally raised revenue is essential for one aspect of local control, the ability to have differences in levels of spending among school districts. While extreme spending differences are undesirable, many people believe that moderate differences should be permitted, reflecting differing values about the desirable level of education services.

Two issues are often intertwined—the role of local finance and the level of property taxes. To a great extent, the property tax is *the* local tax for schools. Many people criticize heavy reliance on the local property tax because it is often associated with big inequalities of resources among school districts. But the real root of inequality is reliance on *local revenue*, not the property tax itself. Disparities would generally be even worse if the local income or sales tax were used instead of the property tax.

Table 1. Level and Composition of School Revenue, 1991-1992

	School revenue per pupil	Percentage of total				
		Including federal aid			Excluding federal aid	
		Federal	State	Local	State	Local
United States	**$5583**	**6.6%**	**47.3%**	**46.0%**	**50.7%**	**49.3%**
New England	**6779**	**5.0**	**34.9**	**60.1**	**36.8**	**63.2**
Connecticut	8368	3.9	40.4	55.7	42.0	58.0
Maine	5655	7.0	49.8	43.3	53.5	46.5
Massachusetts	6373	5.8	32.2	62.1	34.2	65.8
New Hampshire	5989	2.9	8.2	88.9	8.4	91.6
Rhode Island	6392	5.4	39.8	54.8	42.1	57.9
Vermont	6881	5.5	32.9	61.6	34.8	65.2
Mid Atlantic	**7925**	**4.8**	**42.1**	**53.1**	**44.2**	**55.8**
Delaware	6128	8.8	67.1	24.1	73.6	26.4
Maryland	6165	5.5	39.9	54.6	42.2	57.8
New Jersey	9302	3.4	42.9	53.8	44.3	55.7
New York	8248	5.1	39.9	54.9	42.1	57.9
Pennsylvania	7392	4.9	44.8	50.3	47.1	52.9
Great Lakes	**5633**	**5.9**	**37.9**	**56.2**	**40.3**	**59.7**
Illinois	5344	7.7	34.8	57.5	37.7	62.3
Indiana	5734	4.9	53.3	41.9	56.0	44.0
Michigan	5850	5.8	26.8	67.5	28.4	71.6
Ohio	5451	5.7	42.1	52.2	44.7	55.3
Wisconsin	6142	4.3	39.9	55.8	41.7	58.3
Plains	**5074**	**6.0**	**43.6**	**50.4**	**46.4**	**53.6**
Iowa	4846	5.7	50.3	44.0	53.4	46.6
Kansas	5107	5.1	42.9	52.0	45.2	54.8
Minnesota	5764	5.0	50.8	44.1	53.5	46.5
Missouri	4850	6.3	37.4	56.2	40.0	60.0
Nebraska	4736	6.2	34.6	59.2	36.9	63.1
North Dakota	4675	10.5	43.5	46.0	48.6	51.4
South Dakota	4269	11.3	26.4	62.2	29.8	70.2
Southeast	**4748**	**8.4**	**53.0**	**38.6**	**57.8**	**42.2**
Alabama	3472	13.3	65.6	21.0	75.8	24.2
Arkansas	4031	9.6	61.8	28.6	68.3	31.7
Florida	5599	7.3	48.4	44.3	52.2	47.8
Georgia	5123	6.8	53.3	39.9	57.2	42.8
Kentucky	4777	9.8	68.6	21.6	76.0	24.0
Louisiana	4308	10.9	55.5	33.6	62.3	37.7
Mississippi	3488	17.2	52.6	30.2	63.6	36.4
North Carolina	5085	6.6	65.1	28.3	69.7	30.3
South Carolina	4786	8.7	48.2	43.1	52.8	47.2
Tennessee	3492	10.5	44.4	45.1	49.6	50.4
Virginia	5284	4.9	33.2	61.9	34.9	65.1
West Virginia	5449	7.8	67.1	25.1	72.7	27.3
Southwest	**4747**	**8.4**	**47.6**	**44.0**	**52.0**	**48.0**
Arizona	4837	9.4	42.9	47.7	47.3	52.7
New Mexico	4628	12.4	74.3	13.3	84.8	15.2
Oklahoma	4092	8.3	63.6	28.1	69.3	30.7
Texas	4851	7.9	44.1	48.0	47.9	52.1
Rocky Mountain	**4457**	**5.9**	**49.1**	**45.0**	**52.2**	**47.8**
Colorado	5120	4.6	39.5	56.0	41.3	58.7
Idaho	3823	8.1	62.1	29.8	67.6	32.4
Montana	4912	8.5	56.3	35.2	61.5	38.5
Utah	3343	6.4	57.1	36.4	61.1	38.9
Wyoming	6315	5.0	49.9	45.1	52.5	47.5
Far West	**5360**	**7.5**	**62.4**	**30.1**	**67.5**	**32.5**
California	5179	8.0	63.6	28.4	69.2	30.8
Nevada	5298	4.2	38.7	57.2	40.3	59.7
Oregon	5840	6.1	30.8	63.1	32.8	67.2
Washington	5662	5.3	73.6	21.0	77.8	22.2
Alaska	7871	12.6	63.6	23.8	72.8	27.2
Hawaii	6138	7.0	91.2	1.8	98.0	2.0

SOURCE: National Education Association, *1992-93 Estimates of School Statistics* (Washington, D.C.: 1992).

Chapter 3
Where the Money Comes From

In a nutshell, state revenue for schools comes mostly from sales and income taxes, and local revenue is overwhelmingly from the property tax. These generalizations apply to most but not all states.

Even though we are concerned here just with revenue for schools, this analysis views state tax revenue as a whole, not taking account of earmarking. As discussed in Chapter 9, state support for schools depends much more on the size of the total revenue pie than on whether portions of particular taxes are earmarked for education.

Table 2 shows the major sources of state and local tax revenue in fiscal year 1991 and how the main components of the tax system varied over the previous 21 years. Many people will be surprised how little the tax burden has changed. In 1991, state and local tax revenue was $11.30 per $100 of personal income, almost exactly the same as in 1970. There have been ups and downs,

Table 2. State and Local Tax Revenue Per $100 of Personal Income, 1970 to 1991

Fiscal Year	Total	Local	State	State				
				General Sales	Personal Income	Corporation Income	Severance	Other
1991	$11.30	$4.62	6.70	2.23	2.14	0.44	$0.12	$1.77
1990	11.47	4.59	6.90	2.29	2.21	0.50	0.11	1.79
1989	11.55	4.55	7.02	2.31	2.20	0.59	0.10	1.83
1988	11.60	4.57	7.05	2.32	2.13	0.58	0.12	1.88
1987	11.48	4.48	7.02	2.26	2.16	0.59	0.12	1.89
1986	11.24	4.37	6.89	2.26	2.04	0.55	0.19	1.85
1985	11.28	4.34	6.97	2.25	2.06	0.57	0.23	1.86
1984	11.30	4.35	6.96	2.21	2.09	0.55	0.26	1.85
1983	10.68	4.25	6.46	2.02	1.88	0.50	0.28	1.78
1982	10.59	4.12	6.49	2.01	1.82	0.56	0.31	1.79
1981	10.85	4.20	6.67	2.07	1.82	0.63	0.28	1.87
1980	11.02	4.26	6.79	2.14	1.84	0.66	0.21	1.94
1979	11.37	4.46	6.94	2.19	1.81	0.67	0.16	2.11
1978	12.08	5.01	7.10	2.21	1.82	0.67	0.16	2.23
1977	12.15	5.17	7.02	2.14	1.77	0.64	0.15	2.32
1976	11.98	5.17	6.85	2.10	1.65	0.56	0.16	2.38
1975	11.74	5.09	6.68	2.07	1.57	0.55	0.15	2.34
1974	11.93	5.16	6.81	2.07	1.57	0.55	0.11	2.51
1973	12.41	5.43	7.01	2.04	1.60	0.56	0.09	2.72
1972	12.24	5.51	6.77	1.99	1.47	0.50	0.09	2.72
1971	11.50	5.26	6.27	1.88	1.24	0.42	0.09	2.64
1970	11.32	5.07	6.29	1.86	1.20	0.49	0.09	2.65

NOTE: Revenue for each fiscal year is divided by personal income in the calendar year that ended during it. State and local taxes do not equal total tax revenue because personal income for the District of Columbia is included in calculating total and local tax revenue per $100 of personal income but not in calculations for state taxes.

SOURCES: For tax revenue, U.S. Census Bureau, *Governmental Finances*, and U.S. Census Bureau, *State Government Finances* (Washington, D.C.: U.S. Government Printing Office, various years). For personal income, unpublished data from the U. S. Department of Commerce with revised estimates as of September 2, 1992.

attributable to tax increases and tax decreases as well as to economic booms and busts, but the overall tax burden has been remarkably stable.[1]

Table 3 provides a more detailed view of state tax revenue in 1991 and compares it to 1980. Once again, there was relatively little change in the overall level of taxation, with tax revenue per $100 of personal income rising slightly from $6.79 to $6.80. Considerable change occurred, however, below the surface. The main shifts were the large rise of the personal income tax, the smaller increase of the sales tax, and the large decrease of the corporate income tax. Among the minor taxes that failed to keep up with personal income are taxes on tobacco products, alcoholic beverages, pari-mutuels, and the severance of minerals. In other words, sales and income tax revenue grew considerably faster than the economy, while revenue from many other taxes lagged behind economic growth.

The changes in state and local tax systems during the 1970s and 1980s reflect both explicit policies and implicit changes resulting from the characteristics of each tax. As discussed in the next chapter, some taxes automatically grow faster over time than others. For example, states have raised cigarette and motor fuel tax rates much more often than personal income or general sales tax rates, but revenue from the latter taxes has grown much faster. Inflation automatically boosts income and sales tax revenue, but it normally has no effect on the revenue from cigarette and gasoline taxes because they are usually based on quantities sold. Income tax revenue grows especially fast because of the tendency for taxpayers to move into higher tax brackets over time.

Local school revenue comes from a much narrower tax base than is available to states. In 1991, 97.4 percent of the tax revenue raised by independent school districts was from the property tax. In only four states—Kentucky, Louisiana, Pennsylvania, and South Dakota—did the property tax produce less than 98 percent of local school revenue. The rest of local school tax revenue came mostly from local income or wage taxes and sales taxes.[2]

Table 3. State Tax and Lottery Revenue per $100 of Personal Income, 1980 and 1992

Tax	1980	1992
Total	*$6.79*	*$6.80*
General sales	2.14	2.23
Personal income	1.84	2.17
Motor fuel	0.48	0.46
Corporate income	0.66	0.45
Motor vehicle licenses	0.24	0.22
Insurance	0.15	0.16
Public utilities	0.17	0.16
Tobacco	0.19	0.13
Property	0.14	0.14
Severance	0.21	0.10
Death and gift	0.10	0.09
Alcoholic beverages	0.12	0.07
Corporation licenses	0.07	0.09
Document transfers	0.04	0.04
Pari-mutuels	0.04	0.01
Other licenses	0.12	0.14
Other	0.08	0.14
Lotteries	0.15	0.16

NOTE: Personal income excludes District of Columbia.

SOURCE: U.S. Census Bureau, *State Government Finances in (year)*; personal income provided by U.S. Bureau of Economic Analysis, estimates as of September 2, 1992.

School property tax revenue per $100 of personal income generally followed the same path as local tax revenue shown in Table 2. That is, it peaked in 1973 and then fell through 1982, in part because of state efforts to provide property tax relief and also due to declining enrollments. Since then it has trended upward. By 1991, it was $1.50, an increase from $1.36 in 1982 but still much less than $1.96 in 1973.[3]

[1] The proportion of taxes paid initially by business has fallen over this period, so tax burdens are more explicit than they used to be. The business share of the property tax has declined because of new exemptions (e.g., for inventories), and the corporation income tax has grown slowly because of the sluggish growth of profits and other factors. Because of interstate competition, states have tended to rely on non-business taxes when they raise tax rates.

[2] The text refers to independent school districts, that is, those that levy taxes themselves rather than receive tax revenue from a municipality or county. Schools in numerous large cities and counties are not independent, and they often share in taxes other than the property tax. If these nonindependent school districts were included, the number of states where schools receive local sales or income tax revenue would be greater. This analysis is drawn from Steven D. Gold, et. al., ed., *Public School Finance Systems of the United States and Canada*, vol. 1 (Albany: Rockefeller Institute of Government and American Education Finance Association, 1992), p. 16.

[3] U.S. Census Bureau, *Governmental Finances* (year); and U.S. Department of Commerce for personal income, as in Table 2.

Chapter 4
A Framework for Comparing Taxes

A dollar is a dollar is a dollar. But all taxes are not the same. Some taxes have more growth potential. Some taxes are fairer. Some taxes hurt the economy less. Some taxes are easier to administer. Revenue from some taxes is more stable. Advocates of increased education spending must consider these differences, which are important for political, social, and economic reasons.

No tax is perfect. All taxes involve some inequities, and they nearly always interfere with efficient resource allocation to some degree.

The higher a tax's rate, the more glaring its imperfections. From this, two important principles follow:

- States should avoid over-reliance on any particular tax. In other words, they should strive for *balance* by using all of the appropriate major taxes available.
- *Broad tax bases* are desirable. That is, exemptions should be avoided if possible. A sales tax with few exemptions, for example, can have a lower tax rate and still produce the same amount of revenue as a sales tax with a narrow tax base.

At least eight attributes of taxes are important—fairness, responsiveness to economic growth, competitiveness, administrative cost, compliance cost, stability, political salability, and exportability.

Fairness

Two kinds of equity are often distinguished—vertical and horizontal. Vertical equity refers to whether a tax takes an increasing or decreasing share of household income as income rises, that is, whether it is progressive or regressive.

Most state-local tax systems are regressive at low income levels because states usually obtain more revenue from taxes on consumption than from taxes on income.[4] Many people consider that undesirable because it violates the idea that taxes should reflect ability to pay.

The second aspect of fairness is horizontal equity, which implies that people who are equally well off should pay the same tax. Most taxes violate this principle to some degree: income tax and sales tax exemptions favor some people over others, resulting in unequal tax burdens, and unequal assessments of homes cause some homeowners to pay much more property tax than others whose homes have the same value.

Some theorists focus on another kind of fairness, the idea that taxes should be related to the benefits received from government. This concept is difficult to apply to education programs because part of the benefits accrue to students and their families and another part benefit society in general.

Unfortunately, tradeoffs may exist among these various aspects of fairness. For example, eliminating a sales tax exemption could increase horizontal equity but make the tax more regressive.

Responsiveness to economic growth

Because the cost of education tends to rise over time due to inflation and growing enrollment, it is desirable for tax revenue to grow steadily as well. But taxes differ considerably in terms of how they respond to economic growth.

Economists refer to this phenomenon as the *elasticity* of a tax, and they measure it by calculating the percentage increase in tax revenue that occurs when personal income grows 1 percent. A tax that grows proportionately with personal income has an elasticity of

[4] Citizens for Tax Justice, *A Far Cry from Fair* (Washington, D. C., 1991). The distribution of tax burdens is somewhat controversial because of the large number of assumptions that must be made in order to analyze it. Many studies find that state-local taxes as a share of current income are proportional for 85% to 90% of the population, but they generally find taxes to be regressive at low income levels. The property tax is particularly difficult to analyze because assessment practices vary widely and often increase regressivity by over-assessing property in low-income neighborhoods.

When Is a Tax Regressive or Progressive?

Suppose that a certain tax costs the average family with a $40,000 income $1,000 annually, but a family with twice as much income typically pays $1,800. Is that tax regressive or progressive?

Many people might assume that the tax is progressive because the $80,000 family pays 80 percent more than the $40,000 family. But that is not how these terms are used by economists when they analyze taxes.

For a tax to be progressive, it must take a bigger share of income from the wealthier family. In this example, the tax takes 2.5 percent of income at $40,000 and 2.25 percent at $80,000, so it is regressive, not progressive.

To analyze regressivity and progressivity, one has to know how tax liability varies by income level. For a personal income tax, this depends not just on tax rates but also on exemptions, deductions, and exclusions. Even a tax with a flat tax rate is progressive if it allows each person to exempt a fixed amount of income. For example, Connecticut's new income tax is 4.5 percent of income after subtracting a standard deduction of $24,000 per family. Since the tax is zero at low income levels and rises as a proportion of total income above $24,000, it is progressive.*

For sales taxes and other taxes on particular consumption items, like gasoline or cigarettes, regressivity results because people tend to spend a smaller proportion of their income on taxable items as their income goes up. For the general sales tax, this is simply because rich people can afford to save a bigger share of their income than can people with lower incomes; so the tax is a bigger share of income at lower income levels.

Analyzing business taxes is complicated because assumptions need to be made about who ultimately bears the burden of the tax—consumers through higher prices, workers through lower wages, or owners through lower profits? The answer varies depending on the nature of the tax and the markets in which the firm operates.

* For example, the 4.5% tax for a family with income of $30,000 is calculated on just 20% of its total income ($30,000 minus $24,000); but the tax on a $100,000 income is based on its entire income because the standard deduction is phased out at high income levels.

1.0. Taxes that grow proportionately faster than income are said to be elastic. Taxes that grow proportionately slower than income are referred to as inelastic.

One of the top tax policy priorities for most states should be to increase the elasticity of their tax system. Many states have structural deficits, with the spending needed to maintain current services rising faster than the growth of revenue. By increasing the elasticity of the tax system in ways discussed in Chapter 5, states can reduce this gap.

Competitiveness

Taxes tend to distort economic activity. They can affect where consumers spend their money, where people live, and where businesses locate. They can also bias choices, helping one product and penalizing another. These effects usually interfere with the efficient allocation of resources in the economy. In general, the less this occurs, the better.

There is one important exception. Taxes on cigarettes, alcoholic beverages, and other products that produce social costs may actually improve resource allocation because they discourage use of those products.

The distortions caused by taxes are directly related to how high their rates are. Because state and local income tax rates are usually much lower than federal rates, their disincentive effects are much smaller. In addition, income and property taxes are deductible on the federal income tax, which reduces their impact on the behavior of people and businesses.

An example may help to clarify these issues. Some people argue that state income taxes encourage high income people to move from one state to another or that they discourage saving and investing. To see how significant this is, suppose that an executive could reduce his state income tax liability from $10,000 to $6,000 by moving from one state to another. The $4,000 annual saving shrinks to $2,560 if he is in the 36 percent federal tax bracket because his itemized deductions will decrease by $4,000, raising his federal tax payment by $1,440. Thus, the federal deduction reduces the incentive to move in response to state income taxes.

As for the incentive to save, his federal marginal tax rate is 36 percent and his marginal state tax rate is perhaps 7 percent. If he receives $1,000 worth of

dividends, he retains only about $570 after paying $360 federal tax and $70 state tax. Clearly, the federal tax is much more of a disincentive to save than the state tax.[5]

Administrative and Compliance Costs

Administrative and compliance costs refer to the costs of collecting and paying taxes incurred by the government and by taxpayers, respectively. The costs of processing sales and income tax returns by the revenue department and the expense of assessing property at the local level are administrative costs. The fees of income tax preparers and the time people spend keeping their records in order to help prepare income tax returns are examples of compliance costs.

For a given set of taxes, administrative and compliance costs are hardly affected if tax rates are increased. But if a new tax is imposed, extra administrative and compliance costs are incurred. This supports a policy of raising taxes that already are in effect rather than enacting new ones, at least to the point at which those existing taxes become so high that their negative effects are prohibitive.

Stability

It is desirable for a tax to produce revenue steadily, without big fluctuations from year to year. If revenue is very unstable, a state or school district will have more difficulty balancing its budget.

Unfortunately, there is often a tradeoff between elasticity and stability. For example, while increasing reliance on the personal income tax raises the elasticity of tax revenue, it also makes it somewhat more unstable. But this tradeoff is not always present. Extending the sales tax to services that are growing rapidly and steadily can increase both stability and elasticity.

Political Salability

Some taxes are not as objectionable politically as others, making them more attractive for advocates of higher spending. Surprisingly, the attitudes toward particular taxes differ considerably from state to state. Opposition is usually less to increasing an existing tax than to enacting a new one.

One reason for the political popularity of business taxes is that often their burden is hidden from taxpayers. This could be because they are exported from the community, that is, paid by residents of some other part of the country or the world, or it could be because the local people who bear the burden of the taxes do not realize it. How can they know that prices are higher or wages lower because of some business tax?[6]

The political attractiveness of taxing business is offset by the competitiveness factor: If business taxes are far out of line with those imposed in other places, the local economy may suffer. In fact, the proportion of state-local taxes with an initial impact on business has trended downward for decades.[7] (Economists differentiate the initial impact of a tax from its incidence, which refers to the identity of the people who ultimately bear its burden. The impact of a property tax on a factory, for example, is on the business, but its incidence is on people, either the owners, customers, or suppliers of the business.) Competitiveness is even more important now than in the past because American businesses are much more exposed to international competition than they were before the 1980s.

Exporting Tax Burdens

A favorite principle of taxation is "Don't tax me. Don't tax thee. Tax that fellow behind the tree." Exporting taxes is not only good politics, but sometimes it is good economics.

There are two kinds of exporting—to the federal government and to non-resident individuals.

- Taxes can be exported to the federal government if they are deductible on corporate or individual tax returns.[8] Businesses can deduct all state-local taxes, but individuals can deduct just income and property taxes, and only then if they itemize deductions.

  An example shows how this works: Suppose a family pays $10,000 in state income and local property taxes. This lowers its federal taxable income by $10,000. If its federal tax rate is 28 percent, its federal tax bill is cut $2,800. So the net cost of paying the $10,000 is just $7,200. You can say that $2,800 of the tax burden was exported to the federal government.

  This obviously creates a big incentive for a state to rely more on income and property taxes

[5] This example does not consider that the state tax is deductible on the federal return, which reduces the combined tax bill to somewhat less than $430.

[6] If the tax cannot be passed on in higher prices, it may fall on the company's stockholders, who are often not local residents. This will make the community a less attractive place to invest, which could depress local wages and land values.

[7] For an analysis that covers 1957 to 1980, see Andrew Reschovsky et al., *State Tax Policy: Evaluating the Issues* (Cambridge, Mass.: Joint Center for Urban Studies, 1983), p. 127-152.

[8] Of course, the federal government does not pay taxes. When deductibility reduces its revenue, it must either borrow more, spend less, or raise its own taxes. All of these policies impose burdens on citizens nationally.

and less on sales and excise taxes. If a state must choose between a $200 million income tax increase and a $200 million sales tax increase, it should recognize that the income tax option will cost many of its citizens considerably less because it lowers their federal tax payment. The savings could be $20 million or more, money that will remain in the state rather than head to Washington.[9]

- Taxes can be exported to tourists who pay sales and other consumption taxes when they vacation in a state, and they can also be exported to non-resident business owners if a business cannot shift a tax. Business taxes are difficult to shift to out-of-state customers when they are on products that must compete with products from other states that levy lower taxes.

The Intergovernmental Dimension

No state is an island (except Hawaii). It cannot develop its tax policy without considering what other states are doing. As mentioned above, this is especially true in the 1990s because interstate economic development competition is so fierce. States are justifiably concerned about their business climate.[10]

Competition causes states to pay a price—higher unemployment and weaker economic growth—if their taxes are too far out of line with their neighbors or with other states where their businesses might locate.

The competition factor can easily be overplayed or distorted:

- *All tax increases are not the same.* It is primarily when a state's taxes are much higher than its neighbors' (or the national average) that they are likely to have a serious negative impact on the economy. States with low or moderate taxes do not need to be nearly as concerned as states that already have relatively high taxes.
- *Services matter too.* If higher taxes are used to improve schools, this can provide a boost for economic development. States with poor education systems are likely to be also-rans in the economic development competition. In other words, tax increases do not hurt a state's competitive position if the new revenue is used to enhance services that businesses value highly.

There is another intergovernmental aspect in considering tax options for schools. The revenues of local school districts cannot be considered in isolation from the revenues of other local governments. In many states, cities and counties are already imposing sales or income taxes; they also impose property taxes. This can limit the capacity to use those taxes for funding schools.

Putting It All Together: Why Balance and Broad Tax Bases Are Important

There are three reasons why a state should have a balanced tax system, one with substantial reliance on income, sales, and property taxes, as well as taxes on businesses and charges for users of government services in cases where they are appropriate:[11]

- It helps to keep tax rates low, which is good for economic development competitiveness.
- It will often make the tax system more stable because revenue is less subject to fluctuations in yields from particular taxes.
- It will often be fairer and distort resource use less than an unbalanced tax system because it tends to "average out" the defects of each tax.

In addition, it is good tax policy to have broad tax bases:

- A broad base helps to keep tax rates low (which is desirable because high tax rates tend to distort location decisions).
- A broad base is fairer because it improves horizontal equity.
- A broad base makes the tax system easier to administer and understand (because artificial distinctions are avoided).

[9] The amount of tax exported depends on how many people itemize federal deductions and their federal tax rate. The proportion of individual returns that are itemized varies from state to state. In 1991, the average was 29%.

[10] Because of its remoteness from the Mainland and the unusual character of its economy, Hawaii does not have to be as concerned with keeping its tax policies aligned with those of other states. Even Hawaii, however, is not immune from competitive pressures.

[11] The U.S. Advisory Commission on Intergovernmental Relations (ACIR) has recommended relatively strict adherance to balance, with each of the three main taxes accounting for about one-third of tax revenue. This has been criticized in Helen F. Ladd and Dana R. Wiest, State and Local Tax Systems: Balance among Taxes vs. Balance among Policy Goals, in Frederick D. Stocker, *The Quest for Balance in State-Local Tax Structures* (Cambridge: Lincoln Institute of Land Policy, 1987), p. 39-69.

- A broad base may make the tax system more responsive to economic growth (if the exemption eliminated is for something that has a relatively high income elasticity, like certain kinds of services).
- A broad base may enhance stability (if the exemption eliminated is for something, such as food, whose use is relatively stable).

Conclusion

The ideal tax is horizontally and vertically equitable, can be exported, does not harm competitiveness, and has low administrative and compliance costs but high stability and high political salability. Unfortunately, in the real world tradeoffs are inevitable. The best solution is a balanced combination of income, sales, property, business, and excise taxes. All of the taxes should have broad tax bases and moderate tax rates.

Chapter 5
The State Tax Options

The options available for increasing revenues can be viewed as a menu. Nine potential choices at the state level will be discussed in this chapter. Chapter 6 analyzes four choices for local taxes.

The nine options for increasing state tax revenue are the following:

- Increasing personal income tax rates
- Broadening the base of the personal income tax
- Reducing indexation of the income tax
- Increasing the sales tax rate
- Broadening the base of the sales tax
- Increasing business taxes
- Increasing excise taxes
- Imposing a state property tax (or increasing its rate)
- Expanding lotteries and other forms of gambling

Before examining these nine options, it is important to emphasize that the choices are not the same for every state.

If a state is already making heavy use of a tax source, it should probably look to a different tax for more revenue. As discussed in Chapter 4, there is much to be said in favor of a tax system that makes balanced use of a variety of taxes. A balanced tax system sometimes enhances equity and stability and enables a state to avoid high rates for particular taxes, which is desirable for competitiveness.

Differences in the composition of the tax base, the nature of the state's economy, and the policies of competing states also influence where a state should look for revenue.

While all nine options hold some potential, they are not of equal importance. If a state needs substantial revenue that will grow significantly over time, the sales and income taxes are the places to look. Excise taxes, business taxes, and gambling have limited potential. A state property tax can raise a great deal of money, but it is rarely an attractive choice because the property tax is such an important local revenue source for schools and because the property tax is even less politically popular than other taxes.

Take another look at Table 3. The personal income and general sales taxes accounted for nearly two-thirds of state tax revenue in 1992, and that proportion has been pushing inexorably higher over the years. Even a big percentage increase in any other tax will have a relatively small impact on the state financial picture.

Unfortunately, there are no huge mysterious pots of gold sitting at the end of the rainbow that will painlessly produce revenue. States have a limited number of revenue options, and they have all been used somewhere already.[12] What appears innovative in one state is "business as usual" in another.

Increasing Personal Income Tax Rates

An increase in personal income tax rates should be near the top of the list in most states. It has three big advantages: progressivity, responsiveness to economic growth, and federal income tax deductibility.

Progressivity

The personal income tax is the only major state tax that is progressive. Unless it plays a major role in a state's tax system, the system is virtually sure to be regressive.

The progressivity of state income taxes varies greatly, depending not only on tax rates but also on the tax base. (Broadening the tax base is discussed in the next section.)

During the first four years of the 1990s, nearly all of

[12] The list could of course be expanded. Perhaps the biggest omission is increasing reliance on fees. The biggest fee opportunities involve higher education tuition and highway tolls; both of these sources are usually earmarked for programs other than elementary-secondary education. They can, however, reduce the need for general revenue for those programs and thus help to provide more revenue for schools.

Criteria for Evaluating Tax Options

The nine tax options discussed in this chapter will be considered in terms of the nine criteria discussed in Chapter 4:

- Progressivity
- Horizontal equity
- Responsiveness to economic growth (elasticity)
- Competititveness
- Administrative cost
- Compliance cost
- Stability
- Political salability
- Exportability

the states that increased the personal income tax made it more progressive. Several states increased progressivity by eliminating deductions that favored the affluent and making other changes in the tax base. But 11 states changed tax rates in ways that shifted the tax burden to high-income taxpayers. Here are the details for joint returns:

- *California* (1991) increased the top tax rate from 9.3 percent to 10 percent for returns with taxable income over $200,000 and to 11 percent for income over $400,000.
- *Kansas* (1992) restructured rates, increasing taxes for returns with taxable income above approximately $44,000.
- *Maine* (1991) imposed a two-year 15 percent surcharge on taxable incomes above $75,000.
- *Maryland* (1992) temporarily increased the top rate from 5 percent to 6 percent for returns with taxable income over $150,000.
- *Nebraska* (1993) enacted a revenue neutral reform, increasing the income tax rate slightly for high income taxpayers and targeting the additional revenue to low and moderate income taxpayers by providing an enlarged personal credit.
- *New Jersey* (1990) increased the top tax rate from 3.5 percent to 7 percent. It did not raise rates at all for returns with taxable income under $70,000.
- *North Carolina* (1991) increased the top rate from 7 percent to 7.75 percent for returns with taxable income over $100,000.
- *Ohio* (1992) increased the top rate from 6.93 percent to 7.5 percent for returns with taxable income over $200,000.
- *Oklahoma* (1990) added an additional tax bracket that applied only to taxpayers with taxable income over $9,950.
- *Rhode Island* (1992) imposed a temporary surcharge on returns with federal tax liability above $15,000 (approximately $90,000 of taxable income).
- *Vermont* (1991) imposed a temporary surcharge on taxpayers whose federal income tax liability was more than $3,400.

The only apparent exceptions to the general trend of making tax rates more progressive were Arizona (1990), Montana (1993), and Pennsylvania (1991). Arizona and Montana are not really exceptions because they repealed major deductions that benefited high income taxpayers disproportionately, so their income taxes actually became more progressive. Pennsylvania was the only state that raised its income tax without increasing progressivity. (Not coincidentally, Pennsylvania's income tax is the least progressive in the country.)[13]

Several comments can be made about the choice between raising tax rates proportionately (across the board) and making them more progressive:

[13] The effects of Montana's reform are complicated. It reduced taxes at low income levels while increasing them at higher incomes, which is progressive. However, it raised tax burdens more for many middle income returns than for high income returns under the federal tax code prior to 1993. The 1993 Montana tax reform has been suspended pending a referendum in November 1994. Pennsylvania imposes a single tax rate and does not have any personal exemptions or standard deductions. All other states have one or the other, making their income taxes somewhat progressive in that the ratio of tax paid to total income goes up as income rises. The most recent comparison of state income tax progressivity is available from the Research Section of the Minnesota Department of Revenue.

How the Income Tax Works

State income taxes differ considerably in how they are designed, but they all have a tax base and tax rates.

Tax base

The starting point in calculating the tax base is usually federal Adjusted Gross Income (AGI). This is much narrower than a taxpayer's total income because it excludes many kinds of income, such as most fringe benefits provided by employers, welfare payments, employee contributions to retirement accounts like 403(b) plans, and so forth. States usually make some modifications in federal AGI and allow taxpayers to subtract personal exemptions and deductions, which may be a standard deduction or itemized. What remains is referred to as Taxable Income.

Tax rates

A typical tax schedule might look like this:

Under $5,000	2%
$5,000–$20,000	$100 plus 4% of excess over $5,000
$20,000–$50,000	$700 plus 6% of excess over $20,000
$50,000–$100,000	$3,700 plus 8% of excess over $50,000
Over $100,000	$7,700 plus 10% of excess over $100,000

Tax credits

Tax credits are amounts subtracted from tax liability, for example, for child care expenses.

Illustrative tax calculations

Economists differentiate between *marginal tax rates* and *effective tax rates*. The *marginal tax rate* is the tax on the last dollar earned. For example, in the schedule above a taxpayer with taxable income of $120,000 would have a marginal tax rate of 10%. If she earned an extra $10, her tax would go up $1. But a taxpayer with taxable income of $30,000 would have a marginal tax rate of only 6%. As these examples show, marginal tax rates can be read right off the tax tables.

The *effective tax rate* is the proportion of total income taken by the tax. Suppose that the taxpayer with $120,000 of taxable income had total income of $150,000. (The difference is due to deductions like mortgage interest, non-taxed fringe benefits, and personal exemptions.) Her tax would be $9,700, which represents 6.5% of her total income. Note that this is considerably less than the marginal rate of 10%.

Another example: The person with taxable income of $30,000 would pay tax of $1,300. If his total income was $35,000, his effective tax rate would be 3.7% and the marginal rate would be 6%.

This is a progressive tax because the effective tax rate of the higher income person is considerably higher.

- Even if the increase is proportional, the tax system becomes more progressive over all because the income tax will contribute a bigger share of revenue.
- If the tax increase is limited to returns with very high incomes, it will produce much less revenue than if it applies to middle income tax returns. In fact, a big increase in revenues cannot be generated by taxing only the very affluent. New Jersey is the one of the few states where the increase produced substantial revenue: it started at a lower level than most of the other states ($70,000 for joint returns and $35,000 for individuals), and New Jersey is the second most affluent state in the nation.
- The potential revenue from taxing the affluent is constrained by interstate tax competition, particularly if the rate exceeds 10 percent. High income tax rates tend to lead some affluent people to move to other states and may discourage business investment.

Table 4 shows the top tax rate in each state as of January 1994. As it makes clear, the highest tax rate in many states starts at a relatively low level of taxable income. The top rate is reached at $25,000 or less in 20 of the 41 states that impose an income tax. This reflects the fact that many states have not changed their tax rate structure in many years. What was a relatively high income in 1970 may be a low or moderate income today.

Having the highest tax rate take effect at a low income level has mixed effects. It tends to increase income tax revenue, but it reduces the progressivity and

the elasticity of the tax. It makes the state income tax more like a flat tax since the lower tax rates tend to become increasingly less important over time.

Responsiveness to economic growth

A second major advantage of increasing income taxes is that it raises the elasticity of the tax system. The income tax is the only major tax that has an elasticity higher than 1.0; that is, its revenue outpaces the growth of the economy. States need heavy reliance on the income tax to offset the low elasticities of most of their other taxes.

States can also increase the elasticity of the income tax by making rates more progressive. As income rises, this automatically generates more tax revenue. An example illustrates how this works: Suppose that initially a state has a flat tax with a rate of 5 percent. It then changes the tax rates so that the first $40,000 of taxable income is taxed at 4 percent, and higher income is taxed at 6 percent. A family with $80,000 taxable income would pay $4,000 under both the new and the old tax structures. But then suppose its taxable income rises to $90,000. Under the old tax system, its liability would be $4,500. But under the new tax system, it would be $4,600. The elasticity of the tax system for this family has risen from 1.0 to 1.022. The more progressive tax is also more elastic, so tax revenue rises more in response to a given increase in income.

If a state already has relatively high income tax rates that are not very progressive, it can enact a revenue neutral reform that does not increase total income tax revenue immediately but that does raise progressivity and increase the income tax's elasticity. By making this change, revenue will grow more in the future. This is what Nebraska did in 1993 on a small scale. It raised its top rate from 6.9 percent to 6.99 percent while increasing tax credits that provide relatively larger benefits at low income levels.

During the 1980s the elasticity of many income taxes was reduced because of the trend to flatten tax rates. This was one of the themes of the federal tax reform of 1986, and many states made similar changes at about the same time. Thus, state personal income tax revenue became less responsive to the growth of the economy than it used to be. The shift toward more progressive policies in the 1990s has reversed this trend.

Exportability

A third advantage of increasing the personal income tax is that it is usually the only state tax that is deductible on federal income tax returns. This is important to taxpayers who itemize federal deductions. In 1991, 29 percent of returns were itemized nationally, but the figure was higher in many states (e.g., Michigan, 33%; Massachusetts, 34%). However, because itemizers tend to be relatively affluent and have bigger households than non-itemizers (many of whom are single), they account for a higher proportion of voters and tax payments than their share of tax returns. In 1991, about half of returns with Adjusted Gross Income between $30,000 and $50,000 itemized; for income between $50,000 and $75,000, over 75 percent; and above $75,000 income, more than 90 percent.

The value of a deduction is found by multiplying it by the taxpayer's marginal tax rate. In the example from Chapter 4, a $10,000 state income tax payment deducted at the federal income tax rate of 28 percent cuts the federal tax bill by $2,800. In effect, it costs the taxpayer only $7,200 to pay the state income tax. If the same $10,000 were raised from the sales tax or an excise tax, it would cost individuals the entire $10,000.

Other considerations

Increasing the income tax rate has a number of possible drawbacks:

- It may be more difficult politically than obtaining revenue in some other manner. An income tax increase restricted to the affluent does not encounter much resistance, but its revenue potential is limited. An across-the-board income tax increase is a tougher sell.
- Because income tax revenue is sensitive to economic fluctuations, it is relatively unstable.[14] The greater the elasticity of the tax, the more its yield may decline during a recession.
- If income tax reliance is already high, increasing the tax rate may have a negative effect on a state's economic competitiveness. The extent to which this occurs is controversial. It cannot be conclusively proved, but it is widely believed among tax researchers and other observers of state tax policy.[15]

Two other considerations favor increasing the

[14] The sales tax is not particularly stable either, if it exempts food and otherwise has a narrow base. The best policy for coping with revenue instability is maintenance of a sizable Rainy Day Fund.

[15] It is difficult to isolate the effect of taxes because many other factors affect competitiveness. Research by Michael Wasylenko of Syracuse University and others showed that high income taxes were associated with slower employment growth in the 1970s, but the statistical relationship apparently did not continue in the 1980s. See Robert Carroll and Michael Wasylenko, Do State Business Climates Still Matter?—Evidence of a Structural Change. *National Tax Journal* 47 (March 1994) p. 19-37.

Table 4. Highest Marginal Tax Rates for State Personal Income Taxes, Joint Returns, January 1994

		Highest nominal rate	After deducting federal taxes	Taxable income level at which top rate starts (thousands of $)
New England				
	Connecticut	4.50%	4.50%	$0
	Maine	8.50	8.50	32
	Massachusetts	5.95	5.95	0
	Rhode Island[a]	10.89	10.89	250
	Vermont[a]	9.90	9.90	250
Mid-Atlantic				
	Delaware	7.70	7.70	40
	Maryland	6.00	6.00	150
	New Jersey	7.00	7.00	150
	New York	7.88	7.88	26
	Pennsylvania	2.80	2.80	0
Great Lakes				
	Illinois	3.00	3.00	0
	Indiana	3.40	3.40	0
	Michigan	4.60	4.60	0
	Ohio	7.50	7.50	200
	Wisconsin	6.93	6.93	20
Plains				
	Iowa[b]	9.98	6.03	48
	Kansas	6.45	6.45	60
	Minnesota	8.50	8.50	86
	Missouri	6.00	6.00	9
	Nebraska	6.99	6.99	47
	North Dakota[a]	5.54	5.54	250
Southeast				
	Alabama[b]	5.00	3.02	6
	Arkansas	7.00	7.00	25
	Georgia	6.00	6.00	10
	Kentucky	6.00	6.00	8
	Louisiana[b]	6.00	3.62	100
	Mississippi	5.00	5.00	10
	North Carolina	7.75	7.75	100
	South Carolina	7.00	7.00	11
	Virginia	5.75	5.75	17
	West Virginia	6.50	6.50	60
Southwest				
	Arizona	7.00	7.00	150
	New Mexico	8.50	8.50	64
	Oklahoma	7.00	7.00	10
Rocky Mountain				
	Colorado	5.00	5.00	0
	Idaho	8.20	8.20	20
	Montana[c]	7.70	7.70	0
	Utah[b]	7.20	5.77	8
Far West				
	California	11.00	11.00	414
	Hawaii	10.00	10.00	41
	Oregon	9.00	9.00	10

NOTES: Omitted states tax either no income or only dividends and interest. Income shown is the level at which the highest rate starts, rounded to the nearest thousand dollars.

[a] State tax is a percentage of federal tax payments. Calculation assumes that federal tax rate is 39.6%.

[b] State allows deductibility of federal tax payments in calculating state personal income. This deduction has the effect of making the actual state tax rate lower than the nominal rate. The second column assumes that federal tax rate is 39.6%. In some states, deduction is optional or limited. Rate shown is the one that would be paid by typical high income taxpayer. States where the deduction does not affect high income taxpayers at the margin are not noted.

[c] The table reflects 1993 law that has been suspended pending a voter referendum.

income tax. According to some adherents of the idea that taxes should be related to the benefits provided by government, the income tax is particularly appropriate for funding education because its benefits correlate well with subsequent earnings. Also, the state income tax scores fairly well on horizontal equity in that it imposes similar burdens on similarly situated taxpayers. However, this is not usually a major issue for policymakers or the public.

Broadening the Personal Income Tax Base

Broadening the tax base refers to eliminating or phasing out provisions that reduce the amount of income subject to taxation. No income tax covers all income. Four kinds of provisions reduce income tax revenue:

- *Personal exemptions* shield a certain amount of income for each member of a household.
- *Exclusions* permit certain kinds of income to escape taxation. Examples are interest on state and local bonds, welfare payments, and most employee benefits.
- *Deductions* are expenditures that can be subtracted in calculating income subject to tax.
- *Credits* are similar to personal exemptions and deductions except that they are subtracted directly from tax liability rather than from taxable income.

A strong case can be made for tying the provisions of a state income tax in some manner to the federal income tax. This makes it much easier for taxpayers to compute their state tax liability and for the state to administer the tax. In fact, most of the 41 state income taxes are tied to federal taxable income and adjusted gross income or to tax liability and itemized deductions.

There are two principal ways to gain revenue by broadening the state income tax base:

1. *Eliminating provisions that are more generous than the corresponding federal tax provisions.*

One example is the treatment of Social Security. As of 1993, only 15 states had adopted the federal rule that half of Social Security benefits are taxable if a couple has income above $32,000. (The other states completely exempt Social Security benefits. The 1993 federal tax increase raised the taxable portion of Social Security to 85 percent for joint returns with taxable income over $44,000.)[16] Most states also give larger tax breaks to pensions than those allowed by the federal government. The most generous states are shown in Table 5. Likewise, most states do not phase out the benefits of their personal exemptions for affluent taxpayers, as the federal government does. Eight states allow federal tax payments to be deducted in whole or in part.[17] Many states allow other unusual deductions.[18]

2. *Not permitting certain deductions.*

The most far-reaching policy is not to allow any itemized deductions at all. That was done by West Virginia in 1987. Another target in six states is to deny a deduction for the prior year's state income tax payments in calculating this year's liability.[19]

There is, however, a practical limit on how broad a state should make its tax base. States should not tax income that the federal government exempts: to do so entails burdensome record keeping for taxpayers and is difficult to administer.

States have wisely been moving in the direction of broadening their income tax base in recent years. Since 1990, three states (Arizona, Kentucky, and Montana) repealed the deduction for federal tax payments, one state limited it (Missouri), and two states (Colorado and Mississippi) eliminated the deduction of state tax payments. Because these deductions represented a bigger proportion of income for the affluent, their repeal made the state income taxes more progressive.

Income tax base broadening has considerable potential for some states and a modest degree of potential for most states. It depends on how broad a state's existing tax base is.

Base broadening enhances horizontal equity because it makes the tax liability of households with a certain level of income more similar. Its other effects depend on the nature of the provision being considered:

- It may increase the responsiveness of income tax revenue to economic growth; taxing pensions, for

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[16] The states that taxed Social Security in the same manner as the federal government in 1992 were Colorado, Connecticut, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, New Mexico, North Dakota, Rhode Island, Utah, Vermont, West Virginia, and Wisconsin. U. S. Advisory Commission on Intergovernmental Relations (ACIR), *Significant Features of Fiscal Federalism, 1993 Edition, Part 1* (Washington, D. C.), p. 64-67.

[17] One hundred percent of federal tax payments are deducted by all taxpayers in Alabama, Iowa, and Louisiana. The deduction is limited in three states (Missouri, $10,000; Oregon, $3,000; and Utah, 50%) and is optional in two states (North Dakota and Oklahoma), but most taxpayers in the latter two states opt for a tax schedule that cannot be used if federal taxes are deducted.

[18] For example, most states do not tax lottery winnings. Alabama, Massachusetts, and Missouri allow a deduction for Social Security taxes paid. For details see *Significant Features of Fiscal Federalism*, p. 58-71.

[19] Arizona, Georgia, Hawaii, Louisiana, New Mexico, and Oklahoma are the only states that still allow this deduction, except for the three states where the state tax bill is a percentage of federal liability. Colorado and Mississippi repealed this deduction in 1992.

Table 5. Exclusions of Private Pension Income from the Personal Income Tax

State	Provision
Alabama	Full exclusion for defined benefit plans*
Colorado	$20,000
Hawaii	Full exclusion
Illinois	Full exclusion for benefits under certain IRS sections
Mississippi	Full exclusion
New York	$20,000*
Pennsylvania	Full exclusion

* This state also exempts all government pensions.
SOURCE: *Significant Features of Fiscal Federalism, 1993 Edition*, p. 64-67.

example, increases elasticity because retirement income will grow rapidly as the population ages.

- Repealing itemized deductions affects the progressivity of the income tax depending on how deductions proportionately benefit taxpayers with above-average income.[20] Lower income households are much more likely to claim a standard deduction. Phasing out benefits of exemptions at high income levels also increases progressivity.
- Politically, this strategy can be difficult. Groups that benefit from special tax breaks usually fight hard to retain them.

Reducing Indexation of the Income Tax

Sixteen states adjust some features of their personal income tax to eliminate the effects of inflation. They may adjust tax brackets to prevent people from facing higher tax rates merely because of higher prices, and they may also increase the value of personal exemptions (or credits) and the standard deduction to prevent their erosion by inflation.

The result of this indexation is to reduce the growth of state income tax revenue. If a state wants to increase revenue in future years, it can repeal indexation or limit its effect, for example, by setting a maximum allowable inflation adjustment or by subtracting, say, 2 percent from the inflation rate used in making indexation adjustments.

These actions are actually variants of the two policies discussed earlier in this chapter. Eliminating indexation of tax brackets amounts to increasing effective tax rates, and a failure to index a personal exemption or standard deduction is a way of broadening the income tax base.

Proponents of indexation claim that it promotes accountability by preventing unlegislated tax increases. They have a point. But in response it can be observed that many other state taxes, like those on cigarettes, do not respond at all to inflation, so their effective rate is reduced by higher prices. Not indexing the income tax offsets the lack of adjustment of other taxes for higher prices.

Indexation helps to prevent the progressivity of the income tax from being eroded by inflation. If indexation is stopped or limited, a state would have to take other actions to avoid its tax system becoming more regressive. For example, it could periodically increase a tax credit that benefited low- and moderate-income taxpayers.

Another point is that in seven states eliminating indexing would violate the automatic tie-in between state taxes and the federal income tax code, which is indexed for inflation. Thus, it would change the nature of the state income tax in these states and make it somewhat more complicated because a taxpayer could no longer simply carry over calculations from his or her federal tax return to a state tax return.

Increasing the Sales Tax Rate

Most of the large state tax increases dedicated to schools in the 1980s relied on increasing the sales tax rate. Its advantages can be stated concisely: a sales tax rate increase is simple, raises a lot of money, and spreads its burden widely, so that it does not impose large new tax burdens on any particular group.

Regressivity

An important disadvantage is regressivity: the sales tax takes a bigger proportion of income from low income

[20] Michael Ettlinger of Citizens for Tax Justice argues that itemized deductions do not disproportionately benefit the affluent, emphasizing that they are a much lower proportion of Adjusted Gross Income for returns with income above $200,000 than at the $50,000-$75,000 level. His analysis excludes deductions for state and local taxes; deductions tend to rise as a proportion of AGI up to $75,000.

Credits to Offset Sales Tax Regressivity

Nine states provide refundable credits to offset the regressivity of the sales tax. Usually these credits are subtracted from income tax liability, but if the credit is greater than the tax bill, a rebate is paid.

The credits vary widely in how they are designed. In Hawaii, for example, the credit is $55 per personal exemption for a family with income under $6,000. It is reduced gradually as income rises, falling to $10 for income between $20,000 and $30,000. No credit is provided for families with income over $30,000.

In Vermont, the size of the credit is based on a matrix constructed on the number of people in the family and household income. The credit increases with family size but the amount per person diminishes; likewise, as income rises, the credit falls in value.

A simpler way for a state to provide a credit is to establish an earned income tax credit that is a percentage of the federal earned income credit, as six states do. The federal credit is for low income working families with income under about $25,000. For example, Minnesota's credit is equal to 15 percent of the federal credit.

(The federal earned income credit in 1994 is 30% of wages earned up to $8,425 if a worker has two or more children, so its maximum benefit is $2,528. Once wages exceed $11,000, the credit is gradually reduced, until it is eliminated for wages above $25,300. The credit is smaller if a worker has no children or only one child, but an increase passed in 1993 is still being phased in, so it will be more generous in 1995 and 1996. Thereafter, the wage levels and maximum benefits are indexed for inflation.)

By establishing an independently designed sales tax credit or piggybacking on the federal earned income credit, a state can target tax relief to low and moderate income people to offset the regressivity of a sales tax increase.

households than from high income households.[21] The degree of regressivity depends on what is in the sales tax base, particularly whether food and utilities are exempt. If they are not taxed, regressivity is considerably reduced although not eliminated.

The regressivity problem can be further mitigated by combining a sales tax increase with some other measure that targets tax relief at low and moderate income households. The net effect of the package need not be regressive. For example, nine states have a refundable income tax credit to offset the regressivity of the sales tax. Six states have an earned income tax credit.

Other disadvantages

Sales tax revenue usually has a considerably lower elasticity than the income tax. In fact, in many cases, the elasticity is less than 1.0, meaning that revenue grows more slowly than the economy.[22]

The elasticity and stability of a sales tax depend on the composition of its base. The demand for food is not very responsive to income growth, so if food is taxed the elasticity tends to be lower while revenue stability is greater. In contrast, consumer demand for services is increasing strongly. If many services are taxed, the elasticity of the sales tax tends to be higher.[23]

Another disadvantage of increasing the sales tax rate is that the revenue is not deductible for federal tax purposes. This makes it less attractive than increasing the personal income tax or the property tax, both of which are allowable deductions.

Broadening the Sales Tax Base

States differ considerably in how they define taxable sales. Twenty-six states exempt food, 29 states exempt residential utilities, and 6 states exempt clothing. Most state sales taxes originally applied only to sales of goods

[21] The regressivity of the sales tax is based on calculations that use a household's current income. Some economists analyze regressivity from a different perspective. If the tax is compared to "normal income," much, if not all, of the regressivity disappears. When people have a temporary reduction in their income, they do not usually decrease their spending proportionately. This makes their sales tax a bigger proportion of their current income. Such people may be counted as being poor in a particular year although they normally are not poor.

[22] A survey of elasticity estimates is provided in Robert H. Aten, Technical Notes on the State-Local Model, in U. S. Treasury Department, *Federal-State-Local Fiscal Relations, Technical Papers* (Washington, D. C., 1986), vol. 2, p. 576-577. Although both income and sales taxes now have lower elasticities, the survey shows that the elasticity of the income tax tended to be considerably higher than that of the sales tax.

[23] Personal business services (brokerage charges and investment counseling, bank services, and legal services) have a high elasticity, but personal consumer services (e.g., cleaning and repair of clothes and shoes, barbers and beauticians, auto repair, and domestic household services) have a relatively low elasticity, according to a study by Richard F. Dye and Therese J. McGuire, Growth and Variability of State Individual Income and General Sales Taxes, *National Tax Journal* xliv (March 1992), p. 55-66.

rather than services; although all states now tax some services, the extent of service taxation varies widely.

Eliminating sales tax exemptions is a better policy in some respects than raising the sales tax rate, but it shares some of the same advantages and disadvantages. To complicate issues further, the repeal of various kinds of exemptions has differing effects. Taxing some goods or services is more regressive than taxing others, and there are also important differences in effects on elasticity, stability, and administrative costs.

First, what can be said about sales tax base broadening in general? One big advantage is that it can produce substantial revenue without increasing tax rates. This is particularly important as tax rates increase because the economic distortions caused by tax rates grow as their level increases. (One of the most important distortions is causing shoppers who live near state borders to make purchases in neighboring states.) Broadening the sales tax base normally also enhances horizontal equity.

Expanding the sales tax base, however, is normally regressive, although the degree of regressivity varies. If food or utilities are taxed, that increases regressivity, but if the tax is applied to goods or services used relatively more as income rises, regressivity is reduced. For example, imposing the sales tax on luxuries like country club dues, pet grooming, and landscaping is progressive, but those types of services are the exception rather than the rule.[24]

Casual intuition is not necessarily a reliable guide in analyzing regressivity. To many people it appears to be common sense that a tax on a necessity like clothing would be regressive. But high income people spend a lot more money on clothing than poor people. So the tax on clothing may actually not be regressive.

Another disadvantage of base broadening is that the sales tax is not deductible on federal personal income tax returns.

As mentioned above, the effect of broadening the sales tax base depends on what is taxed:

- If a state taxes something that is growing faster than the existing sales tax base, that raises the elasticity of the total sales tax. This is particularly important for many kinds of services.
- If the tax is applied to a good or service for which demand does not fluctuate much over the business cycle, that increases the stability of the sales tax. Food for home consumption is the best example, although taxing it is extremely regressive.[25]
- Base broadening may either increase or decrease the problem of administering and complying with the sales tax. For example, repealing the exemption for nonprescription drugs makes the tax simpler to administer because such products are often hard to distinguish from those that are taxable. (For example, in New York, this exemption leads to dandruff shampoo being exempt while regular shampoo is not; sterilized cotton is exempt, but nonsterilized cotton is taxed.)[26] On the other hand, applying the sales tax to candy while exempting food is difficult to administer, and taxation of some services raises administrative challenges.[27]
- The politics of base broadening vary. A broad proposal to eliminate exemptions risks stirring up a host of campaigns to preserve each individual exemption, so many states have backed off after contemplating major base broadening. But considerable broadening has occurred incrementally. If the policy is characterized as loophole closing, it may be more politically acceptable.

The taxation of services is particularly important because their role in the economy is growing so rapidly.[28] When states first began to impose sales taxes in the 1930s, the tax usually applied only to goods. This

[24] For estimates of the progressivity or regressivity of various potential components of the sales tax base, see Citizens for Tax Justice, *Nickels and Dimes (Washington, D.C., 1988).*

[25] John L. Mikesell, Fiscal Effects of Differences in Sales Tax Coverage: Revenue Elasticity, Stability, and Reliance, National Tax Association, *Proceedings of the Eighty-fourth Annual Conference: 1991*, p. 50-57. Mikesell finds that sales taxes in states with broad bases tend to have lower elasticity and higher stability, presumably because the inclusion of food in the tax base tends to dominate other differences in coverage.

[26] Richard D. Pomp, Simplicity and Complexity in the Context of a State Tax System, in Steven D. Gold, ed., *Reforming State Tax Systems (Denver: National Conference of State Legislatures, 1986), p. 135.*

[27] William F. Fox. See, e.g., Sales Taxation of Services: Has Its Time Come? in William F. Fox, ed., Sales Taxation (Westport, Connecticut: Praeger, 1992), P. 51-61. James Francis reports, however, that Florida was able to overcome the problems in administering its short-lived sales tax on services; see his article, The Florida Sales Tax on Services: What Really Went Wrong? in Steven D. Gold, ed., The Unfinished Agenda for State Tax Reform (Denver: National Conference of State Legislatures, 1988), p. 129-152. The difficulties in administering a broad sales tax on service could be overcome over time as experience was gained with it and the tax's features were adjusted to reflect administrative difficulties.

[28] This was demonstrated in a NASBO study that contrasted sales tax trends in New Mexico, which taxes most services, and Georgia and Tennessee, which tax relatively few services. Marcia A. Howard, *The Revenue Potential of Taxing Services* (Washington, D.C.: National Association of State Budget Officers, 1991).

policy has become increasingly untenable as time passed, and all states tax at least some services now.

The Federation of Tax Administrators publishes periodic surveys showing how many services are taxed in each state. It divides services into eight categories:

- Utilities
- Personal services
- Business services
- Computer services
- Admissions and amusements
- Professional services
- Fabrication, repair, and installation
- Other services

The number of services covered in each of these categories by each state is shown in Table 6, which reflects the fact that some services are taxed under excise taxes or gross receipts taxes rather than sales taxes.

Most economists draw a sharp distinction between taxation of consumer and business services. Taxing consumer services (such as appliance repairs, telephone service, cable television, lawn care, barbers and beauticians, and so forth) gives them the same treatment as consumer goods. There is no economic reason for allowing consumer services to escape taxation while taxing goods. Adding consumption services to the tax base levels the playing field for all types of consumption, removing a bias in favor of purchasing services.

Business services are a different matter. As discussed below, businesses often shift the burden of taxes to consumers. If they are not passed along, the taxes tend to hurt the competitiveness of industries. Taxing services also distorts business decisions by creating an incentive to provide services in-house rather than purchase them. States need to judge how serious these problems with taxing business services are. If the tax rate is low, the distortions are less than if the tax rate is high.

All business services are not alike. It makes no sense for a state to tax companies that are highly mobile because they can move to another state to avoid the tax. An example is mutual fund companies. In contrast, many services require close proximity of customers and providers, such as security services, repairs of office equipment, and maintenance. States tax those services without worrying about their moving away. (Assuming that they are passed along to business customers, however, such taxes add to the cost of doing business in a state, making it somewhat less attractive as a place to locate or expand.)

Advertising is a special case. For six months in 1987, Florida imposed a broad tax on services, but it was repealed after television and radio stations and newspapers waged an intensive campaign against it. One of the practical lessons from this experience is that service taxes should exempt advertising because the media has so much power to affect public opinion.[29]

The details of how a service tax is designed make a big difference. For example, services should be taxed on the basis of their *destination* rather than their *origin*. That is, a state should tax services that are used within its borders rather than services that are produced locally for customers elsewhere. If an origin approach were used, it would place in-state service providers at a big disadvantage compared to their competitors located in other states.[30]

The verdict on taxing services is mixed. Politically, it is easier to tax business services than consumer services, but taxing consumer services makes more sense economically. Although imposing the sales tax on business services is not ruinous for the economy, it does entail some economic problems.

States can obtain significant revenue increases from both consumer and business services, but the revenue potential in business services is greater,[31] so it is tempting to tax them. The economic damage done by the tax depends on the level of the tax rate (the higher, the worse) and on the nature of the business. States should be careful to avoid taxing service providers who are highly mobile.

Broadening the sales tax base has been a common policy in the past several years. In 1990, 1991, and 1992, at least 23 states eliminated some sales tax exemptions.[32] Most of these actions involved relatively small amounts of revenue, but Connecticut, New Jersey, and Pennsylvania gained significantly from base broadening.

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[29] Francis, The Florida Sales Tax on Services, p. 142-144.

[30] This issue has been stressd by Fox, "Sales Taxation of Services."

[31] Analyses showing the growing share of services in personal consumption expenditures exaggerate the revenue potential from taxing them unless states are willing to impose the sales tax on health services, which few will do. The surprisingly low elasticity of revenue from personal services is shown in Dye and McGuire, op cit, and John L. Mikesell, General Sales Tax, in Gold, ed., *Reforming State Tax Systems*, p. 211-230. Nevertheless, the revenue from taxing consumer services is substantial; Mikesell estimates that a shift from taxation of no services other than utilities, transient lodging, and admissions to taxation of repair, installation, and maintenance of tangible personal property and selected services rendered by commercial establishments—including personal care—can increase sales tax revenue by 12% to 15%. It should be noted that over 80% of the revenue from the Florida sales tax on services was from business services.

[32] The Federation of Tax Administrators reports an even higher figure, indicating that 28 states added new business services and 27 added new personal services to their sales tax base between 1990 and 1992. *Tax Administrators News* (November 1992). Some of this increase probably reflects more accurate reporting rather than a change in tax provisions.

Table 6. Number of Services Taxed by Category and State, November 1992

	Utilities	Personal services	Business services	Computer services	Admissions/ amusements	Professional services	Repair & installation	Other services	Total
Alabama	9	2	6	1	10	0	1	3	32
Alaska	0	0	0	0	0	0	0	1	1
Arizona	12	2	5	3	11	0	2	25	60
Arkansas	14	3	5	1	11	0	11	7	52
California	4	2	3	1	1	0	3	5	19
Colorado	4	0	2	1	2	0	3	3	15
Connecticut	9	11	20	6	13	0	14	11	84
Delaware*	7	20	34	6	10	8	19	37	141
District of Columbia	10	7	11	6	6	0	13	10	63
Florida	7	4	8	3	13	0	16	14	65
Georgia	10	3	2	1	11	0	2	6	35
Hawaii	14	20	34	6	13	8	18	42	155
Idaho	0	3	4	0	11	0	6	5	29
Illinois	12	0	1	1	0	0	1	1	16
Indiana	8	4	3	2	2	0	0	5	24
Iowa	13	15	18	0	13	0	14	22	95
Kansas	10	10	9	2	13	0	16	16	76
Kentucky	10	1	4	0	7	0	3	1	26
Louisiana	12	8	4	1	7	0	13	8	53
Maine	9	1	6	3	2	0	4	2	27
Maryland	5	3	11	1	11	0	3	2	36
Massachusetts	9	1	4	0	1	0	2	3	20
Michigan	10	4	6	1	1	0	2	2	26
Minnesota	15	6	11	2	13	0	4	10	61
Mississippi	8	4	8	3	10	0	13	23	69
Missouri	8	1	2	1	11	0	0	5	28
Montana	12	0	0	0	3	0	0	4	19
Nebraska	14	6	5	3	11	0	5	4	48
Nevada	0	1	4	0	1	0	2	3	11
New Hampshire	8	1	0	0	0	0	0	2	11
New Jersey	6	2	6	0	6	0	14	11	45
New Mexico	16	20	33	6	13	8	18	41	155
New York	9	5	15	4	7	0	16	18	74
North Carolina	10	4	4	1	8	0	1	1	29
North Dakota	6	1	2	0	10	0	1	1	21
Ohio	8	5	8	2	1	0	12	6	42
Oklahoma	7	1	4	2	11	0	0	6	31
Oregon	0	0	0	0	0	0	0	0	0
Pennsylvania	8	6	17	6	1	0	15	8	61
Rhode Island	10	1	6	3	3	0	3	2	28
South Carolina	4	5	6	4	9	0	1	3	32
South Dakota	10	19	28	6	13	4	18	32	130
Tennessee	11	11	6	3	12	0	13	14	70
Texas	12	11	14	6	11	1	11	13	79
Utah	7	7	5	2	8	0	13	7	49
Vermont	3	2	4	1	10	0	2	1	23
Virginia	1	3	4	0	1	0	4	5	18
Washington	16	20	34	6	10	8	15	43	152
West Virginia	10	17	26	4	13	1	13	26	110
Wisconsin	11	11	6	1	13	0	14	13	69
Wyoming	11	7	6	2	7	0	16	15	64

SOURCE: Federation of Tax Administrators, *Sales Taxation of Services*, 1992.
* Services are taxed through a business gross receipts tax. Delaware does not impose a general sales tax.

Increasing Business Taxes

There are several kinds of business taxes. By far the most important is the corporation income tax. Many states accompany it with a tax on the capital invested in a company, which is often referred to as a franchise tax. (To make it confusing, some states refer to the corporate income tax as a franchise tax.) In addition, there are usually some taxes on specific industries, like banking, telecommunications, insurance, and perhaps utilities.[33] Finally, states can impose taxes on gross receipts or value added.

Aside from these state taxes specifically on business, it is important to recognize that businesses also pay other taxes. For most businesses in most states, the local property tax accounts for the biggest share of the total tax bill. In addition, a significant portion of the sales tax is paid initially by businesses. In comparing state business taxation, those taxes may be highly significant. This section, however, is concerned only with *state* taxes that are specifically on businesses.

Although business taxes often have some potential as a revenue source, that potential is rarely enough to provide a large continuing increase in school funding. To keep the analysis uncluttered, the corporation income tax will be discussed first, with following discussions of taxes on gross receipts, value added, and invested capital.

A Framework for Analyzing Business Taxes

It is often said, "Businesses don't pay taxes. People pay taxes." There is an important element of truth in this aphorism that undermines many citizen attitudes about tax policy. Most of the public believes that every dollar of tax imposed on a business is one less dollar that people have to pay. Many of them also believe that businesses are rich, so they can afford to pay. They may also think that since many businesses are not locally owned, the tax burden is exported from the community.

But once it is granted that people not businesses bear the burden of taxes, a vital question arises—*which people? Is it the owners of the company, its customers, its employees, or its suppliers?*

- If it is the owners, the tax is progressive, and the burden often will be shifted out of the state.
- If it is the customers or workers, the burden will usually be regressive, and often it will be borne locally.

The ultimate burden of a tax depends on what kind of tax it is and what kind of company it is imposed on (e.g., does it sell locally or nationally? Is its market competitive, an oligopoly, or a regulated monopoly?). From a political standpoint, the subtleties of who pays the tax are less important than the fact that the burden is hidden.

Offsetting the political attractiveness of imposing taxes on business is the risk of hurting the local economy. Taxes are not the most important factor affecting business location decisions. The cost and quality of labor, proximity to markets and suppliers, and perhaps the regulatory environment are more important. Also reducing the influence of taxes on location is the fact that they are deductible on federal corporate income tax returns. But taxes do matter when other factors balance out. As long as a state is not far out of line with its competitor states, taxes do not matter much. But if a state goes overboard in taxing business, that is not good for its business climate.[34]

Business lobbyists often emphasize the particular taxes that put the state in the worst light, that is, the features of the tax system that are harshest for business, ignoring other features that are beneficial. That is a biased way of viewing taxes. A state needs to know how its entire tax structure looks compared to those of other states.[35] It can afford to be high on one tax if it is low on others.

Corporation Income Tax: Advantages

1. Like other business taxes, the burden of a corporation income tax is hidden.
2. If both the owners and the customers of the company are not local residents, the burden of the tax often can be exported from the state.

Corporation Income Tax: Disadvantages

1. Revenue is unstable because corporate profits fluctuate widely over the course of the business cycle.
2. For more than a decade, revenue has been growing relatively slowly, in part because profits have also grown slowly but also probably because of stepped up corporate efforts to limit tax liability.

[33] These taxes are not discussed here, although most of the analysis of general business taxes applies to them.

[34] Tim Bartik, *Who Benefits from State Economic Development Policies?* (Kalamazoo: Upjohn Institute. 1991); article by Carroll and Wasylenko cited in footnote 15; and Pomp, op cit.

[35] A good example of the kind of comparative information states should consider is Wisconsin Revenue Department, *Corporate Tax Climate: A Comparison of Nineteen States* (Madison, 1989).

3. Compliance and administrative costs are high. It is a complex tax to pay and a very difficult one to administer well.

4. Considerable controversy and uncertainty surround the question of who ultimately bears the burden of state corporation income taxes. Some economists believe that at the state level the tax is regressive, even though it is probably progressive at the federal level. The reason is that most states use a three-factor formula (sales, property, and payroll) to figure how much of a company's profits are subject to taxation in a particular state. This turns the tax into a tax on sales, property, and payroll. By contrast, there is no such formula at the federal level, so the tax falls on invested capital.[36]

Value Added and Gross Receipts Taxes

Value added and gross receipt taxes are rare. One merits strong consideration, but the other should be avoided.

Michigan is the only state with a value added tax. Its Single Business Tax was adopted in 1975 as a replacement for the corporation income tax and many other business taxes. In 1993, New Hampshire broadened the base of its general business tax so that it is close to being a value added tax.[37] Washington imposes a gross receipts tax instead of a corporation income tax. Delaware, Hawaii, Indiana, and New Mexico also impose this tax on businesses, along with a corporation income tax.

The essential difference between these taxes is that the gross receipts tax is on a company's entire sales, while a value added tax permits a company to subtract its purchases from other firms. For example, if a company sells $100 million worth of products and purchases $30 million of inputs from other firms, its value added is $70 million and its gross receipts are $100 million.

Economists generally denounce the gross receipts tax because it results in pyramiding of tax burdens. That is, there is often a tax on a tax. After one company pays the tax and sells to another, the second company must pay the tax again. This provides an artificial incentive for companies to buy their suppliers as a method of reducing their tax bill. (Such a combination of customers and suppliers is referred to as vertical integration.) It also favors large companies over small ones because they have greater capacity to be self-sufficient rather than purchase inputs from suppliers.

By contrast, a value added tax avoids imposing a tax on a tax. It does not per se favor large firms over small ones, nor does it favor unincorporated businesses over corporations or firms that are labor intensive over those that are capital intensive.

Both the value added tax and the gross receipts tax have some advantages over the corporation income tax. Their revenue is much more stable because it is not based on profits, which fluctuate considerably over the course of the business cycle. They also can produce substantial revenue with a relatively low tax rate because their bases are so broad.

Although the value added tax does not provide an incentive for vertical integration, it is usually strenuously opposed by small businesses because (unlike the corporation income tax) they have to pay it even if they are not incorporated. In response to small business lobbying, Michigan exempted most small businesses from its value added tax.

Another feature of the value added tax is that companies pay it even if they are not profitable. To many economists, this is as it should be because they view business taxes as payments for benefits provided by government, not as a reflection of ability to pay.

The value added tax is generally recognized to be regressive. Whether this contrasts with the state corporation income tax is controversial because there is disagreement about whether that tax is progressive or regressive.

The bottom line: The value added tax can produce substantial revenue with relatively low rates and a high degree of stability. A major hurdle it faces is legislators' and governors' lack of familiarity with it. But if any major new revenue source is to emerge in the 1990s, the value added tax is a leading candidate. It could replace many existing business taxes, including the corporation income tax, and generate more revenue over time than they would.

In general, business taxes have limited potential as a source of expanded school revenue. Intense interstate tax competition constrains the ability of states to tax business.

Taxes on Invested Capital

Nearly two-thirds of the states have general business taxes based on how much capital is invested in a company. Sometimes these taxes are in addition to corporation income taxes, although they may substitute for them as well.

[36] Ronald C. Fisher, *State and Local Public Finance* (Glenview, Illinois: Scott Foresman, 1987), p. 226-228.

[37] The New Hampshire business enterprise tax applies to a company's salaries, wages, interest payments, and dividends; it must be paid by unincorporated businesses and nonprofit organizations as well as corporations. For a brief description, see Val Berghaus, New Hampshire's Business Enterprise Tax, *State Tax Notes* (September 13, 1993), p. 590-592.

Revenue from taxes on invested capital is much more stable than that from taxes on corporation income. In combination with a corporate income tax, these taxes can serve as a sort of minimum or baseline tax, assuring that large companies pay a significant amount of tax even if they are able to report little if any taxable income to a state.[38]

Increasing Excise Taxes

Excise taxes are another option with limited revenue potential. As Table 3 showed, their contribution to state tax revenue is relatively small, and in most cases it fell considerably in the 1980s. The most productive state excise tax is on motor fuels, but it is normally earmarked for highways. The cigarette tax is one of the easiest taxes to increase. Raising the cigarette tax is beneficial because it tends to reduce the health problems caused by smoking, but it has four major drawbacks:

- It does not produce growing revenue year in and year out because tobacco sales are declining and the cigarette tax is nearly always levied on a per pack basis that does not reflect inflation.[39]
- It is very regressive.
- Its revenue potential is not great. Even a big increase produces relatively little revenue compared to the amount usually spent on school aid. Besides, the higher the tax rate, the greater the problem of bootlegging from other states or shifting sales to Indian reservations (where the state tax is not imposed).
- The federal government is likely to increase cigarette taxes sharply to help fund health care reform, resulting in a smaller tax base for the states.

Other excise taxes have many of the same problems as the cigarette tax. Alcoholic beverage taxes could be raised considerably, but they do not produce a great deal of revenue. These taxes currently raise only a little more than half as much as tobacco taxes. Taxes on hotel bills and restaurant meals are good tools for exporting burdens in states with large tourist industries, but their revenue potential is relatively small. Insurance premium taxes are constrained by the threat of retaliation: if one state increases taxes on out-of-state insurance companies, other states will increase the tax on companies from the first state.

Increasing a State Property Tax

Raising the property tax is anathema in many states. In fact, one of the most common reasons for increasing state school aid has been to reduce uncomfortably high local property taxes.

But in some situations a state property tax is an option that merits consideration, particularly if a state already has high income and sales taxes and low property tax rates. There are two major reasons:

- As discussed in Chapter 4, a good tax system has balance among all three major potential tax bases—property, income, and sales. This helps to avoid high tax rates on any particular tax base.
- If the geographic distribution of the property tax base is highly unequal, a state property tax makes it possible to even out tax burdens. In particular, without a state property tax, school districts with high property value per pupil may be low-tax enclaves. A state property tax makes it possible to prevent property in those areas from escaping the typical tax burden elsewhere in the state.[40]

A special case can be made for taxing industrial property on a statewide basis. This would eliminate competition among local governments within the state to attract businesses by offering them property tax breaks and would considerably reduce the extent of variation in local tax bases. Besides, assessments could be more accurately and efficiently determined by the state than by local assessors. Assessing industrial property is particularly difficult for local assessors because of its specialized nature.

As discussed in the next chapter, states should not increase reliance on the property tax unless they have accurate assessment systems and provide property tax relief to offset the burden of the tax on low income households.

Gambling

Revenue from legalized gambling does not offer a sound basis for increasing school funding. As of early 1994, three-quarters of the states already have conventional lotteries and pari-mutuel betting. A boom is occurring in casinos, with barriers that prevented their

[38] Robert Strauss, State Reaction to Federal Corporate Changes in the 1980s: More Money or More Uncertainty?, *Proceedings of the Eightieth Annual Conference, National Tax Association: 1987)*, p. 11-20.

[39] The latter problem can be overcome by indexing the cigarette tax rate.

[40] This can also be dealt with through a foundation aid plan by requiring that school districts impose a high minimum tax rate.

spread crumbling across the nation. There is also considerable interest in expanding video lotteries and keno games.

Gambling has considerable attraction because it appears capable of generating substantial revenue without imposing involuntary taxes and, in the case of casinos, because it promises to stimulate economic development and create a large number of jobs.

Nevertheless, as a revenue source for schools, gambling entails a number of serious problems:

- *Unreliable fluctuations.* After an initial burst of excitement when a lottery or casino gaming is introduced, revenue often recedes. In the case of lotteries, it rebounds only when the state stimulates demand through advertising and the introduction of new games. Year-to-year variation in gambling revenue is substantial.
- *Increasing competition from other states.* Casinos are, of course, the foundation of the Nevada economy, but they play a relatively minor role in New Jersey and are practically trivial in Colorado and Iowa, where the size of wagers is sharply restricted by law. As more and more states and Indian reservations have casinos, their novelty value will diminish and they will not be the magnet for distant tourists that casinos have been until now. This implies that the ability to export tax burdens to nonresidents will diminish, as will the potential economic development benefits from gambling.
- *Cannibalism of other state revenue.* People only have so much money to spend. If gambling revenue comes from in-state residents rather than out-of-staters, some of it merely diverts sales and excise tax revenue into gambling revenue. (Likewise, casinos cannibalize revenue from race tracks and lotteries.)[41]

  In the past, Nevada and New Jersey were able to obtain most of their gambling revenue from residents of other states, but as gambling opportunities become more widely available, the out-of-state market will shrink and states will depend heavily on their own residents as sources of gambling tax revenue.
- *Social problems.* Gambling raises issues that other methods of obtaining revenue do not. Aside from regressivity, there is the problem of compulsive gambling. Many people who play lotteries, wager at casinos, and participate in other forms of gambling suffer from a form of addiction, which is abetted by the state when it makes gambling more accessible.

Two other problems are unique to gambling as a revenue source. States often actively promote participation through advertising, conveying a false impression of the likelihood that participants will win money when the odds are high that they will lose. In addition, state promotion of gambling may tend to undermine attitudes toward hard work and entrepreneurship by encouraging a "get-rich-quick" mentality.[42]

Summary

The amount of revenue needed for school aid is so substantial that states are inevitably drawn to their three major taxes when they want to significantly expand resources. Only the sales tax, the income tax, and the property tax can produce enough to make a major difference on a continuing basis. Business taxes, excise taxes, and gambling have much less potential than the big three.

At the beginning of this chapter, the tax options facing the states were described as a menu of choices. Although nine selections are on the menu, some of them are more filling than others. If a state wants a heavy duty meal, it is inevitably drawn to the three major taxes. If revenue needs are less substantial (that is, a snack rather than a banquet), the other options can be considered.

[41] Mary Borg et al., *The Economic Consequences of State Lotteries* New York: Praeger, 1991), p. 60.

[42] William Eadington, a leading authority on gambling, notes that until now casinos throughout the world have been in relatively remote resort areas or have limited access to a select clientele. Big city casinos in close proximity to low and middle income populations are an unprecedented development. Their social and economic effects could differ from those of traditional casinos.

Chapter 6
The Local Tax Options

There are four principal ways of increasing local tax revenue:

- Increasing property tax rates
- Repealing property tax exemptions and credits
- Allowing local income taxes
- Allowing local sales taxes

As in the case of state taxes, these options are not of equal importance. Increasing property tax rates has traditionally been the primary local policy of choice. This could change in the future. While the property tax will very probably remain the dominant source of local tax revenue, sales and income taxes could be used increasingly. Repeal of property tax exemptions has until now not been a significant policy in any state, but it warrants consideration in the future.

As noted in discussing state tax options, the choices are not the same everywhere. If a state has relatively heavy reliance on two taxes and low reliance on a third, it should probably move in the direction of raising the third tax. In considering whether its taxes are high or low, a state should consider its entire tax system, not just taxes for schools. Likewise, if a state has particularly liberal property tax exemptions, curtailing them is a higher priority than in other states.[43]

The property tax often is criticized as being the cause of inequalities in resources among school districts. This criticism is misguided. The disparities result not from *the property tax* but rather from reliance on *local tax bases*. Inequalities would be just as bad if not worse with local income or sales taxes. The cure for this problem is not to change how local revenue is raised but rather to reform how state aid is provided.

[43] Louisiana, where $75,000 of value is exempted for all homes, is the most glaring example.

This chapter does not deal with the question of *how much* should come from local taxation, whether more school resources should come from state or local sources. Rather, it focuses on the narrower issue of *how* local revenue should be raised.[44]

Increasing Property Tax Rates

The property tax is far from perfect, but it is often condemned more severely than it deserves. The property tax has some advantages that balance its disadvantages. Besides, its defects can be mitigated. Don't write off the property tax.

Why should local governments place substantial reliance on the property tax?

- Property is relatively immobile, making it particularly attractive as a local revenue source. Sizable differences in local property tax rates do not cause as much relocation as similar differentials in income and sales taxes would.
- Property tax revenue is considerably more stable and reliable than revenue from other taxes, which are more influenced by economic fluctuations over the course of the business cycle.
- Relying on the property tax helps to avoid higher income and sales tax rates.
- Property ownership is part of ability to pay. Although income is often considered the only measure of ability to pay, taxable income is a flawed measure. Farmers, for example, can often manipulate taxable income by how they time crop and livestock sales and input purchases.

[44] For further analysis of local nonproperty taxes, see two booklets by the U.S. Advisory Commission on Intergovernmental Relations *Local Revenue Diversification: Local Income Taxes* (August 1988) and *Local Revenue Diversification: Local Sales Taxes* (September 1989).

- If property taxes are cut, much of the benefit goes to rich land owners.
- A large share of property taxes can be exported from the local community, either through income tax deductions or by taxes on business property. Considerably larger shares of income and sales taxes are borne locally.[45]

The property tax, however, has some shortcomings. It is widely viewed as regressive at low income levels, and it is a heavy burden on senior citizens. It is often assessed poorly, so that properties with the same value may pay substantially different amounts of taxes. It is based on assessed valuations that tend to increase irregularly, with sudden large jumps following extended periods with little increase.

All of these shortcomings can be mitigated or overcome by the proper state policies:

- Regressivity for poor households can be eliminated with a circuit breaker, a state-financed credit with benefits based on a formula that includes household income and property tax payments. A circuit breaker targets tax relief to low income people, with the benefits offsetting the property tax that has been paid. Most states provide more generous benefits to low income senior citizens.
- The accuracy of assessments can be greatly improved if the assessment function is professionalized, with the state prescribing standards that assessors must meet. Computer technology makes it much more feasible than it used to be to attain a high degree of assessment uniformity.[46]
- Sudden changes in assessments can be avoided if valuations are updated every year or two, as can easily be done with the aid of computer assisted mass appraisal.

How regressive is the property tax? The answer to that question is fairly complicated because the incidence of the property tax varies depending on whether it is on homes, rental property, commercial and industrial enterprises, or land. Most recent economic studies conclude that the property tax is regressive at low income levels and progressive at higher incomes. The regressivity exists because low income renters tend to spend a larger than average share of their income on rent, and low income homeowners (many of whom are senior citizens) tend to have relatively high ratios of home value to income. The progressivity at high income levels is due to the assumption that much of the tax on business property and land is borne by owners of capital, who have relatively high incomes.[47]

Increases in local property taxes for schools can occur either by state mandate, by local decision, or with state encouragement. Many states place a floor under school property tax rates, and that state-imposed minimum can be increased. Other states have implicitly pushed local property taxes higher by requiring school districts to expand their services without providing additional state aid. In states where the state imposes ceilings on local property tax rates, the limits may have to be relaxed for districts that are already making the maximum tax effort allowed.

A final point should be made, which many would regard as an advantage of the property tax. Reliance on a local income or sales tax instead of the property tax implies that a considerably larger share of the tax burden will be borne directly by residents. The business share of the property tax base is normally much higher than its share of the income or sales tax base. Business property often accounts for 35 percent to 50 percent of the total assessed value of property, although that proportion varies from place to place. (It is, for example, lower in a bedroom suburb than in a central city with many office buildings and factories in addition to homes.) Businesses directly pay a much smaller percentage of the sales tax and income taxes.

This difference between property taxes and the two leading alternatives could make it more difficult to increase school revenue through either the income or sales tax alternative. If half of the property tax base is business property, it appears to residents that they can get $2 of tax revenue for every $1 they pay themselves. With an income tax, they have to pay close to $2 of tax to get $2 of revenue.

Repealing Property Tax Exemptions and Credits

At least a quarter of the real property tax base is exempt from taxation, with the proportion much higher

[45] This is not because businesses can more easily shift property taxes than sales taxes but rather because the household share of the sales tax is usually higher than the residential share of the property tax base.

[46] For information on successful approaches to assessment reform, contact the International Association of Assessing Officers (whose headquarters is Chicago) or the Lincoln Institute of Land Policy (which is based in Cambridge, Massachusetts).

[47] Ronald C. Fisher, *State and Local Public Finance* (Glenview, Illinois: Scott Foresman, 1987), p. 145-146.

in some places. Most exempt property is governmental, religious, educational, or charitable. Since this book is concerned with policies that conceivably have a chance of being politically feasible in the 1990s, it is not worth devoting much consideration here to the repeal of such exemptions. Some of these exemptions could be curtailed, but it is unrealistic to believe that much revenue could be gained from that source without a vast change in public attitudes.

Some states, however, could obtain a significant amount of revenue by curtailing general property tax credits, or generous credits and exemptions for homeowners, businesses, or owners of farmland. This is not a significant option for most states because they never established major property tax relief programs of this kind. But if a state has an exemption for all homeowners that subtracts $25,000 to $50,000 or more from the assessed value of all owner-occupied residences, cutting down on the exemption is a viable option that can significantly expand the tax base. Likewise, a few states have general property tax credits that cover as much as 20 percent of the tax bill for all property, with the state government paying for the credit. These provisions, like generous homeowner exemptions, are untargeted and expensive. They do not distinguish among property owners according to how much they need relief; rather, they provide it in a blanket fashion to all.

Curtailing or phasing out such exemptions and credits can be done on a gradual basis over a period of years, which should make it possible to avoid sudden large increases in tax liability. Alternatively, they can be means tested, so that property owners with income above a certain level receive diminished benefits.

There could be some disadvantages to reducing property tax credits for homeowners. Depending on how they are designed, the credits may increase support for property tax increases. Without the credits, resistance to property taxes could increase. Besides, many property tax credits and exemptions are progressive. Instead of simply repealing or cutting them back, states can save money by targeting their benefits.

Some exemptions and credits for business and agricultural property also deserve scrutiny. They may be overly generous or poorly designed to achieve their stated objectives, such as stimulating economic development or preserving farmland. In the interest of accountability, states ought to collect information to measure the cost of these tax breaks, and they should periodically analyze their effectiveness. In practical terms, the issue is usually not whether some sort of special provision should be continued but rather how it should be designed.

Allowing Local Income Taxes

All local income taxes are not the same. They usually differ considerably in structure and incidence from state and federal income taxes. At least three types of local income taxes warrant consideration:

- The oldest kind of local income tax (such as the one in Pennsylvania) is administered locally and is primarily on wages and salaries (and perhaps on the profits of unincorporated businesses). Unlike the state and federal income tax, it does not tax dividends, interest, or capital gains. Because capital income is a bigger share of income for the affluent and because these taxes are levied with a flat rate, this tax is regressive.
- Maryland's county income tax is levied as a percentage of state income tax liability, with the proportion going as high as 60 percent. Since the state income tax is progressive, so is the local income tax.
- Ohio's school income tax is a flat rate applied to state taxable income. Because taxable income is calculated by subtracting personal exemptions, such a tax is slightly progressive.

If a local income tax is permitted, the Maryland and Ohio models are preferable for three reasons: 1) they are much easier to administer because they can be collected with the state income tax rather than requiring that local schools set up a new bureaucracy to collect the tax; 2) they are progressive rather than regressive; and 3) they are fairer because they treat different kinds of income equally rather than taxing only labor income; that is, they are more horizontally equitable.

While a good state-local tax system should derive a substantial amount of revenue from the income tax, the tax is more appropriately levied at the state level than at the local level. If local governments impose income taxes at widely varying rates, high income people have an incentive to move to the places that have lower rates. While the same is true of property taxes, property is less mobile than income.

While the situation may vary from state to state, income per pupil tends to vary considerably more than property per pupil. In other words, fiscal disparities are greater for income than for property.[48]

[48] John H. Bowman and John L. Mikesell, Fiscal Disparities and Major Local Non-Property Taxes: Evidence from Revenue Diversification in Indiana, Maryland, Ohio, and Virginia, *Proceedings of the Seventieth Annual Conference: 1977* (Columbus: National Tax Association), p. 412-423.

The local income tax is not without its advantages. Relying on it rather than the property tax does tend to reduce tax burdens on poor people, but there are other ways of relieving the regressivity of the property tax, as discussed above.

Another advantage of the income tax is that it responds to inflation more quickly than the property tax does because rising prices tend to be accompanied by rising wages. As long as the economy is growing, the income tax tends to produce higher revenue every year without requiring votes to increase tax rates. This contrast with the property tax becomes much less significant if assessments of property are updated every year or two.

It can also be argued that the income tax is a more appropriate revenue source for schools than the property tax. According to the benefit theory of taxation, the property tax should be used only to finance services that benefit property, like police and fire protection and streets. Since schools benefit people not property, this theory concludes that a local income tax is more appropriate for education than a local property tax.[49] A counter argument is that good schools enhance residential property values because families are attracted to the community, so demand for residences is somewhat higher than otherwise would be the case.

Allowing Local Sales Taxes

Much of the analysis of local income taxes applies to local sales taxes as well. The sales tax base is distributed very unequally, with shopping centers making some school districts tax-rich while nearby bedroom communities have little to tax.[50] This problem can be alleviated through a system that requires sharing of revenue among school districts within a county or metropolitan area, but the local sales tax still compares unfavorably to the state sales tax as a source of school revenue.

The main difference between local sales and income taxes is that the sales tax is regressive while the income tax (if it is not just on payrolls) is progressive. If the income tax is only on labor income, however, then the choice is between two regressive taxes. The sales tax is normally more regressive than the payroll tax.

Conclusion

A strong case can be made that a significant proportion of school revenue should come from local sources rather than from state government. Reliance on local taxes increases the risk that fiscal disparities will cause inequalities in school resources, but this problem can be alleviated through state aid.

Two arguments can be made in favor of relying on the property tax for local revenue. First, if a tax system were to be designed from scratch, the property tax would be attractive because property is less mobile than income and sales. Differences in local property tax rates would not distort location decisions as much differences in local sales or income tax rates. Second, in most states the property tax already is the main local tax for schools. If it were suddenly replaced by another local tax, large changes in property values would result; property values would rise because of the elimination of the property tax. These windfall capital gains (a large portion of which would accrue to business rather than homeowners) would perhaps be offset by windfall losses in school districts that were disadvantaged by the switch from property to another local tax. The resulting redistribution of tax burdens and property values could be viewed as capricious.[51]

A final point about the adoption of local sales or income taxes should be made. The choice of a local tax is not independent from the design of the state school aid formula. If income or sales taxes are used as a local revenue source for schools, the measure of local fiscal capacity in the state aid formula should be changed to include sales or income tax capacity and effort. The measure of wealth used for distributing state aid should be the same as the tax base that school districts use to raise revenue.[52]

[49] This argument has been made recently by Professor Robert Strauss of Carnegie-Mellon University. See, for example, his article, Reforming School Finance in Illinois: Some Observations on Principles, Practicalities, and Politics, *State Tax Notes* v (August 16, 1993), p. 351-360.

[50] For evidence that the sales tax base is distributed more unevenly than the property tax base, see Bowman and Mikesell, "Fiscal Disparities and Major Local Non-Property Taxes."

[51] A third argument sometimes used against sales and income taxes is that enacting a new local tax would entail heavy administrative costs. This argument can be dispensed with if the sales or income tax is levied as a supplement to the corresponding state tax, with the state tax department collecting the tax on behalf of the local schools. This is a much more efficient arrangement than having the local government administer the tax, as they do in several states.

[52] Thomas Pogue, School District Fiscal Capacity: Measurement and Equalization, *Proceedings of the Eighty-second Annual Conference: 1989* (Columbus: National Tax Association), p. 17-25.

Chapter 7
Tax Politics

Governors and legislators usually want to be reelected, and increasing taxes is never popular, so any practical discussion of raising taxes has to consider the political dimension. Fortunately, raising taxes to increase school revenue is not as politically risky as the conventional wisdom suggests. This chapter discusses public attitudes about taxes and the tradeoffs between good tax policy and good politics. It also reviews the reasons why the number of tax increases varies so much from year to year and the political repercussions of the large state tax increases that occurred in the 1980s.

Public Attitudes about Taxes

When the public is surveyed about possible large state or local tax increases, a few findings tend to turn up repeatedly:[53]

- Higher sales taxes are preferred over across-the-board income tax increases.[54]
- A cigarette tax increase is near the top of the list in terms of public acceptability.
- Increasing taxes on rich people and businesses is popular, as is loophole closing.
- Increases in existing taxes are preferred over enactment of new taxes.
- Tax increases are more acceptable if they are earmarked for popular programs.

Several general attitudes undergird these findings. Perhaps most important, people tend to prefer taxes that they believe will be paid by someone else. This is an important factor behind the support for taxes on business, rich people, and cigarettes. It also explains why taxes on nonresidents are popular.

Second, the average citizen prefers taxes for which the burden is hidden rather than explicit. This is another reason for liking business taxes, ignoring the fact that in some cases at least part of their burden ultimately is borne by local customers through higher prices and local workers through lower wages. It probably also contributes to the popularity of sales taxes. Although people are aware that they pay the sales tax, it takes relatively small amounts on an almost daily basis, in contrast to the income and property taxes, which are paid in considerably bigger amounts but less frequently.

Several factors help explain the preference for existing over new taxes. A novel tax has much more visibility than a familiar tax. Because it is unfamiliar, people may have unrealistic fears about how onerous it will be. If the new tax is a major one, like a sales or income tax, its adoption usually involves a significant increase in the overall level of taxation; so the issue of *which* tax to increase inevitably becomes entangled with the issue of *how high* taxes will be.

The public's attitude toward an income tax increase depends on how it is increased. It is more popular to increase it on the rich than across the board.

Finally, taxes can be viewed as the price of public services. Much of the opposition to tax increases is based on the view that the government will waste the money or use it for programs that will benefit other people. That is why earmarking is so appealing: It ties a particular program to the higher revenue.

[53] U. S. Advisory Commission on Intergovernmental Relations (ACIR), *Public Attitudes about Taxation and Government Spending* (annual); Steven M. Sheffrin, "Perceptions of Fairness in the Crucible of Tax Policy" (paper presented at Office of Tax Policy Research Conference on Tax Progressivity, Ann Arbor, Michigan, September 1992).

[54] In 1983, ACIR asked, "Suppose your state government must raise taxes substantially. Which would be a better way to do it?" The sales tax beat the income tax, 57% to 23%, with the rest undecided. Ironically, ACIR polls consistently show that more people consider the state sales tax to be "the worst tax, that is the most unfair" than the income tax; both, however, are considered less unfair than the property tax and the federal income tax.

Interest Groups as Obstacles to Tax Increases

It is often politically easier to impose a small tax increase on a large group than to hit a number of small groups with a big tax increase. This is why, for example, the many proposals in the past decade to impose the sales tax all at once on a broad range of services have floundered.[55] Nearly every industry with a service that will be newly taxed will hire a lobbyist and organize its constituents against the base broadening. Nevertheless, considerable base broadening has occurred. It is usually, however, incremental rather than all at once.

Much depends on whether public support for the base broadening can be developed by successfully characterizing it as loophole closing. When one product or group of people escapes taxation, it raises a fairness issue. But this issue often is not communicated well in the public debate.

Another important consideration is timing. If a long period of time elapses between the proposal to broaden the tax base and the final vote on it, opponents have a great opportunity to mobilize against it. If the time is shorter, the chances of adoption are enhanced.

Some organized interest groups oppose a higher sales tax, whether through rate increases or base broadening, because it is regressive. As discussed in Chapter 5, their opposition can be muted or overcome by combining the regressive tax policies with other actions that are progressive.

Tradeoffs between Public Attitudes and Tax Policy Goals

The apparent implication of these attitudes is that advocates of more school spending should propose a tax package consisting of a higher sales tax rate on services and increased taxes on cigarettes, businesses, and the income of rich people, with the revenue earmarked for schools.

How does such a tax package accord with the tax policy principles discussed earlier in this book? The answer varies depending on the shape of a state's existing tax system, but each of these taxes has its drawbacks or limitations.

- Taxes on cigarettes, businesses, and the affluent have limited revenue potential in most states. To obtain enough revenue for a big increase in school funding on a continuing basis, the best options are broad taxes on personal income and sales.
- Cigarette tax revenue grows much slower than personal income, and sales and corporate income taxes often also fail to keep up with economic growth. Only the income tax on the affluent produces revenue that increases faster than the economy expands.
- Many states can safely increase taxes on business and the affluent without significantly hurting their economies, but the potential revenue from these policies is much greater in states where existing taxes are relatively low. States that already have above-average income taxes and business taxes run the risk of hurting their competitiveness with big additional increases in taxes.

One of the best alternatives for increasing school revenue, a broad state income tax increase, does not immediately jump out as one of the most politically attractive alternatives. It has, however, played a big role in some successful efforts to increase state taxes during the past decade,[56] and can be sold on the basis of fairness, especially if increases are greater at high income levels.

Why Tax Increases Vary from Year to Year

Figure 1 shows how the magnitude of state tax increases has varied each year since 1964. The largest increases occurred in 1967, 1969, and 1971, when they added 8 percent or more to total tax revenue. Since the early 1970s, the increases have been smaller, with 1983 and 1991 having the biggest increases, nearly 5 percent each year.

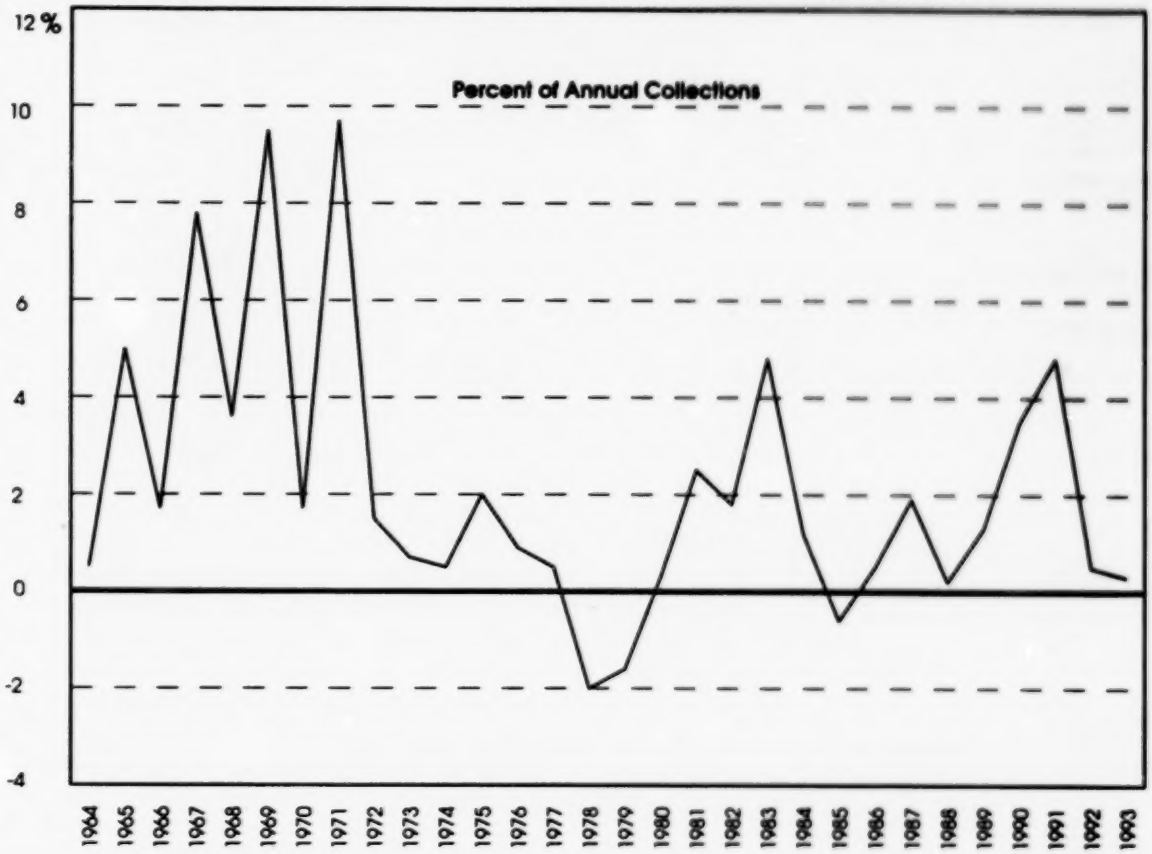
At least three phenomena help to account for the fluctuations in the size of tax increases. The first one is school enrollment. A major reason why taxes rose so much in the 1960s was the cost of educating the baby boom generation. After public school enrollment peaked in 1973, tax increases tended to be much smaller. In fact, enrollment fell about 14 percent in the following 12 years. Now it is rising again, with average increases of 1.5 percent or more in recent years, adding to pressure to raise taxes.

A second factor is recessions. A big tax increase is much easier to sell if a state is in a fiscal crisis, and recessions are the most common cause of crises, since they depress revenue and boost spending for Medicaid,

[55] For example, in Florida in 1987, in Kentucky in 1990, in Massachusetts in 1990-91, and in Washington in 1993.

[56] Among the states that increased income taxes recently are Pennsylvania in 1991 and Kentucky, Nebraska, and Oklahoma in 1990. In the three latter cases, sales taxes were also increased, and most of the revenue from the tax increases was supposed to go to education programs (in Nebraska, to reduce school property taxes).

Figure 1. Net State Tax Changes by Year of Enactment, 1964 to 1993



welfare, and other programs. Tax increases jumped in 1971, 1975, 1983, and 1991—all national recession years.

Of course, some regions have their own recessions while the rest of the country is prospering. An example is the downturn in the Southwest that occurred in the mid-1980s when oil prices collapsed, resulting in tax increases in Louisiana, Oklahoma, and Texas.

The third factor is the election cycle. Because most states elect governors and legislators in even-numbered years, tax increases are more common in odd-numbered years. This is evident from the sawtooth pattern in Figure 1.

The point is that timing is critical. The political environment is usually hostile to raising taxes, but periodically tax increases become more feasible. Proponents of tax increases have to be prepared when the optimal situation presents itself. If they do not take advantage of the window of opportunity while it is open, they may have to wait many years for another chance.

Lessons from Tax Wars of the Last Decade

Contrary to the conventional wisdom, raising taxes is not political suicide. A majority of states have increased taxes significantly at least once since 1983, and in most cases there was little political fallout. Relatively few governors and legislators were defeated because of rising taxes. In the aftermath of a tax increase, political firestorms were the exception rather than the rule.

Consider, for example, what happened in 1991 and 1992. Eighteen states raised taxes significantly in those years (defined as an increase that boosted total state tax revenue by at least 5%). These tax increases caused hardly a ripple in the November 1992 elections. There was virtually no political backlash.[57]

The outcome in Connecticut was particularly impressive because that state had just imposed a broad-based personal income tax for the first time in 1991. A statewide protest movement erupted, and thousands of angry citizens descended on the state capitol. Many candidates ran on a tax protest platform. Yet the overwhelming majority of legislators who had voted for the income tax were reelected. They made a credible case

[57] Steven D. Gold, What Do the 1992 Election Results Say about State Fiscal Policy? *State Fiscal Brief* (November 1992).

that enactment of the income tax was necessary and the best solution available in view of the state's dire fiscal situation.[58]

Of course, such a result is not inevitable. Tax revolts do occur. They usually occur in the wake of political and policy blunders by governors, resulting in sudden large tax increases for which the public has not been prepared.[59]

New Jersey's situation is the one that comes immediately to mind. In 1990 Governor Jim Florio convinced the legislature to pass a $2.8 billion tax increase that was intended to reform school finance, cover a huge state budget deficit, and provide funds for a major property tax relief program. The resulting reaction led to Republicans' winning veto-proof majorities in both houses of the legislature the following year and contributed to his defeat when he sought reelection in 1993.

What went wrong? Florio made a number of mistakes:

> During the campaign in 1989, he promised not to increase taxes. People felt double-crossed when he reversed his position a few months later.
>
> He gave people the impression that he enjoyed raising taxes. He and legislative leaders were all smiles at a press conference to celebrate passage of the tax and budget bill, sending the wrong message. He submitted his proposals shortly before the State Supreme Court issued a ruling overthrowing the school finance system. If he had waited, he might have been able to put more of the blame for the tax increase on the court decision.
>
> He did not convincingly articulate the reasons why taxes had to be raised.
>
> He had an extremely ambitious program, making many reforms that he considered desirable and going far beyond the minimum actions needed to satisfy the court and deal with the state budget deficit. This implied the need to raise taxes considerably more than a less far-reaching program would have required.

New Jersey's experience contrasts sharply with what occurred in Kentucky, which also enacted a very large tax increase in 1990. Responding to a decision by its Supreme Court, Kentucky used most of the revenue from the tax increase to raise school aid and to implement an ambitious school restructuring program. Although both the income and sales taxes were increased by large amounts, the public did not rebel because it accepted the need for the tax increases.

Kentucky's successful experience with raising taxes for schools is consistent with what occurred in at least nine other states that increased the sales or income tax since 1982 (Arkansas, Indiana, Kansas, Nebraska, Oklahoma, South Carolina, Tennessee, Texas, and Vermont). State leaders explained the need for the tax increase and built sufficient public support that there was not a strong backlash when it occurred.

The national news media have a strong tendency to blame public aversion to tax increases for defeats of incumbent governors. For example, when six incumbents were defeated in November 1990 elections, many press accounts placed heavy emphasis on their support of tax increases. In fact, they were in political trouble for other reasons, and support of tax increases was not a major factor.[60]

A study of legislative turnover from 1984 to 1991 found that the negative impact of voting for tax increases is greatly exaggerated. Turnover was virtually the same in states where big tax increases had recently occurred as in states that avoided tax increases.[61]

Two factors appear to differentiate the situations in which tax increases have produced a severe backlash:

- *The size of the increase.* The larger the tax hike, the stronger the probability of a big backlash. This is illustrated not only by New Jersey's experience but also by the reactions to tax increases in Michigan and Ohio in 1983. In both cases, newly elected Democratic governors pushed large income tax increases through their

[58] According to the Taxpayers Alliance to Save Connecticut, of the 58 pro-income tax, anti-repeal incumbents running, 52 were elected; of the 7 House incumbents who lost their bids for reelection, 3 supported the income tax, 3 favored repeal of the income tax, and 1 had an ambiguous position (press release dated November 4, 1992). Income tax supporters also did well in earlier primary races, according to reports by Citizens for Tax Justice.

[59] The most famous tax revolt in recent times was California's Proposition 13 in 1978. It was caused by the political failure of Governor Jerry Brown and the legislature to prevent enormous property tax increases resulting from the interaction of increases in home values with the school finance system and shifts in the composition of the property tax base.

[60] For example, Michigan Governor Blanchard had not raised taxes since 1983, and he had been reelected in 1986. Florida Governor Martinez fought the legislature to keep down the size of tax increases (after initially supporting a sales tax on services). Nebraska Governor Orr did not propose a tax increase, but one occurred because of a miscalculation of how federal tax reform affected state tax revenue. Kansas Governor Hayden suffered because of property tax shifts that followed several decades during which assessments had not been updated.

[61] Michael P. Ettlinger et al., *How Taxes Affect Elections: The Politics of Paying for Government* (Washington, D. C.: Citizens for Tax Justice, 1992).

legislatures, but the political firestorms that resulted had long-lasting effects on the political fortunes of their parties. A smaller increase makes it much harder for would-be tax revolters to cause trouble.[62]

- *Demonstrated need.* To be politically acceptable, tax increases require a strong justification, such as eliminating a serious budget deficit or making it possible to significantly improve schools. Political leaders need to convey the impression that they have exhausted all alternatives to raising taxes.

Timing is crucial to securing enough votes to raise taxes. Most large state tax increases occur in a crisis atmosphere, usually because a recession has thrown the state budget out of balance. Sometimes the crisis is precipitated by a court decision or (rarely) by a widespread perception that services are underfunded.

The point is not that raising taxes is easy or a path to political popularity. Particularly at a time when the average family is on an economic treadmill, resistance to tax increases is formidable. Rather, the point is that raising taxes is not necessarily political suicide. With political skill and effective communication, governors and legislators can increase taxes and survive to serve another day.

[62] Examples of significant tax increases that are not large enough to ignite a serious tax revolt are a one cent increase of the sales tax or the equivalent income tax increase.

Chapter 8
How State Tax Systems Differ

Tremendous differences exist among state and local tax systems. These differences are particularly important because of the theme developed in Chapter 4 that there are strong reasons for tax systems to be similar.

There are, of course, some good reasons why tax systems differ. If a state has a large oil production industry or is a tourist mecca, it can obtain a substantial amount of revenue by taking advantage of those situations. Likewise, if citizens are more or less concerned about progressivity, that should also be reflected in the shape of the tax system. Nevertheless, these reasons for variation among states should not be exaggerated. With oil production much less important than it used to be, one of the major reasons why state tax systems differed has diminished. And stronger interstate tax competition makes it more imperative for tax systems to be alike.

Composition of Tax Revenue

Table 7 compares the composition of state-local tax systems in fiscal year 1991, the latest year for which consistent data are available for all states.[63]

- Personal income tax accounted for 20.8 percent of total tax revenue, but for less than 20 percent in 20 states.
- Sales tax accounted for 23.9 percent of total tax revenue, but for less than 20 percent in 17 states.
- Property tax accounted for 32.0 percent of total tax revenue, but for less than 20 percent in 9 states.
- All other taxes accounted for 23.3 percent of total tax revenue. One component of this miscellaneous revenue is the corporation income tax, which accounted for 3.9 percent of total revenue but for less than 2 percent in 5 states.

Table 8 describes tax systems from a different perspective, showing how much revenue is raised in relation to each state's personal income. In a state like New York, for example, the sales tax is a relatively small proportion of tax revenue but it nevertheless takes a higher proportion of personal income than in most other states. This is because all major New York taxes are higher than average, although the sales tax is not as high as the other taxes. The state sales tax is supplemented by high local sales taxes throughout the state.

Table 8 is probably the most important single table in this book because it highlights the tax or taxes for which each state imposes a lower than average burden relative to personal income. As a general rule, when states want to raise more revenue, they should give strong consideration to raising a tax for which they are below average; the more below average, the higher the priority. This is especially true if the low tax is the personal income tax, because raising it has several other advantages: it is progressive; it increases the responsiveness of tax revenue to economic growth (i.e., it produces more revenue over time); and a significant share of the burden is exported through deductibility on federal tax returns. If the low tax is the sales tax, the state must balance its disadvantages against the desirability of maintaining a relatively high degree of balance among its major tax sources.

Which states are below average for each of the three major taxes? Relative tax levels during fiscal year 1991 are generally still applicable, but legislation over the past several years has caused some states to move from below to above average for certain taxes, or vice versa. Recent changes in tax rates are shown in the appendix to this

[63] This analysis considers combined state-local revenue because state policymakers need to be concerned about local as well as state taxes. This is particularly true for sales taxes, because state and local governments generally impose very similar taxes. It is somewhat less true for the personal income tax, because at the local level these taxes usually differ considerably from state income taxes; local taxes are often only on wages and salaries.

Table 7. Composition of State-Local Tax Revenue, 1991

	Personal Income	Property	Sales	Other
Total	**20.8%**	**32.0%**	**23.9%**	**23.3%**
Alabama	22.0	12.5	30.0	37.5
Alaska	0.0	27.5	3.0	69.5
Arizona	16.6	33.0	32.5	17.9
Arkansas	25.1	18.1	32.7	24.1
California	24.3	28.0	25.9	21.8
Colorado	22.2	35.2	26.2	16.4
Connecticut	5.4	42.7	27.8	24.1
Delaware	34.3	14.9	0.0	50.8
Florida	0.0	37.5	33.9	28.6
Georgia	24.8	28.2	29.4	18.6
Hawaii	26.8	15.0	39.3	32.4
Idaho	26.8	26.6	24.3	23.3
Illinois	18.4	36.8	22.0	15.6
Indiana	25.6	32.8	26.0	39.0
Iowa	24.7	35.2	18.5	21.6
Kansas	18.3	35.8	23.5	22.4
Kentucky	31.9	16.0	20.2	31.9
Louisiana	11.4	16.7	38.1	33.8
Maine	23.1	39.2	19.8	17.9
Maryland	39.0	27.0	13.9	27.1
Massachusetts	36.1	33.6	12.9	17.4
Michigan	21.2	42.4	16.2	20.2
Minnesota	28.6	30.6	19.0	21.8
Mississippi	14.2	26.4	33.1	26.6
Missouri	24.9	23.6	30.8	20.7
Montana	23.9	35.7	0.0	40.4
Nebraska	19.4	38.1	23.2	19.3
Nevada	0.0	23.5	33.4	43.1
New Hampshire	1.7	70.0	0.0	28.3
New Jersey	15.7	45.2	18.8	20.3
New Mexico	13.9	12.9	42.8	30.4
New York	28.8	33.0	18.2	20.0
North Carolina	31.4	22.9	22.1	23.6
North Dakota	10.4	29.1	22.8	37.7
Ohio	30.2	29.2	20.6	20.0
Oklahoma	23.0	15.0	28.8	33.2
Oregon	33.7	43.5	0.0	12.8
Pennsylvania	23.2	29.8	18.6	28.4
Rhode Island	20.1	41.3	20.9	17.7
South Carolina	25.0	27.1	25.9	22.0
South Dakota	0.0	38.9	32.2	28.9
Tennessee	1.4	23.3	44.4	30.9
Texas	0.0	38.7	33.1	28.2
Utah	25.2	26.0	31.7	17.1
Vermont	21.4	43.6	10.4	24.6
Virginia	26.3	32.6	16.7	24.4
Washington	0.0	28.0	48.5	23.5
West Virginia	19.6	16.7	27.8	35.9
Wisconsin	27.2	35.8	18.7	18.3
Wyoming	0.0	40.5	21.3	38.2

SOURCE: U. S. Census Bureau, *Governmental Finances: 1990-91.*

Table 8. State-Local Revenue from Major Taxes per $100 of Personal Income, 1991

	Personal Income	Rank	Sales	Rank	Property	Rank	Total	Rank
Total	**$2.36**		**$2.71**		**$3.62**		**$11.33**	
Alabama	***2.04***	33	2.78	22	***1.16***	50	9.26	48
Alaska	***0.00***	46	***0.67***	46	6.04	2	21.97	1
Arizona	***2.09****	32	4.11	5	4.17	14	12.64	7
Arkansas	2.41	25	3.14*	15	***1.74***	46	9.60	46
California	2.73*	16	2.92*	18	***3.15***	29	11.24	22
Colorado	2.37*	26	2.80	21	3.76	21	10.69	31
Connecticut	***0.57****	41	2.90^	19	4.46	12	10.45	36
Delaware	3.54	8	***0.00***	49	***1.54***	49	10.31	40
Florida	***0.00***	48	3.39	11	3.75	22	10.00	44
Georgia	2.66	18	3.16	14	***3.03***	32	10.75	29
Hawaii	3.81	5	5.59	2	***2.14***	41	14.22	3
Idaho	2.92	13	***2.65***	27	***2.90***	34	10.91	27
Illinois	***1.95***	35	***2.33***	35	3.90	18	10.58	33
Indiana	2.67	17	2.72	24	***3.43***	25	10.46	35
Iowa	2.87	14	***2.14****	38	4.09	16	11.59	17
Kansas	***2.00****	34	2.57*	29	3.92	17	10.93	25
Kentucky	3.71*	6	***2.35***	34	***1.86***	45	11.63	16
Louisiana	***1.34***	39	4.45	4	***1.95***	44	11.70	14
Maine	2.75	15	***2.36****	33	4.66	10	11.90	13
Maryland	4.13*	2	***1.47****	43	***2.86***	35	10.59	32
Massachusetts	3.94^	4	***1.41***	44	3.67	23	10.92	26
Michigan	2.45	23	***1.87***	41	4.91	8	11.58	18
Minnesota	3.63*	7	***2.41****	30	3.88	19	12.68	6
Mississippi	***1.47****	38	3.43*	10	***2.73***	37	10.34	38
Missouri	2.30*	29	2.85	20	***2.19***	40	9.27	47
Montana	2.42*	24	***0.00***	48	3.61	24	10.13	42
Nebraska	***2.22****	31	2.66	26	4.35^	13	11.44	19
Nevada	***0.00***	49	3.46*	9	***2.43***	38	10.35	37
New Hampshire	***0.16***	42	***0.00***	50	6.35	1	9.07	49
New Jersey	***1.74****	36	***2.08^***	39	5.01	6	11.08	24
New Mexico	***1.73***	37	5.34	3	***1.61***	48	12.48	8
New York	4.36	1	2.76	23	5.01	7	15.18	2
North Carolina	3.24*	10	***2.28****	36	***2.36***	39	10.33	39
North Dakota	***1.19***	40	2.61	28	***3.33***	27	11.44	20
Ohio	3.23*	11	***2.20****	37	***3.13***	30	10.71	30
Oklahoma	2.56*	22	3.20	13	***1.67***	47	11.14	23
Oregon	4.06	3	***0.00***	47	5.24^	5	12.05	11
Pennsylvania	***2.35****	27	***1.89****	40	***3.02***	33	10.14	41
Rhode Island	***2.27****	30	***2.38***	32	4.68	9	11.34	21
South Carolina	2.63	20	2.72	25	***2.85***	36	10.52	34
South Dakota	***0.00***	44	3.12	16	3.77	20	9.69	45
Tennessee	***0.13***	43	4.00*	6	***2.10***	42	9.00	50
Texas	***0.00***	45	3.57	8	4.17	15	10.78	28
Utah	2.95	12	3.71	7	***3.04***	31	11.67	15
Vermont	2.58	21	***1.26****	45	5.26	4	12.05	10
Virginia	2.64	19	***1.67***	42	***3.27***	28	10.05	43
Washington	***0.00***	47	5.92*	1	***3.41***	26	12.21	9
West Virginia	2.35	28	3.33	12	***2.00***	43	11.97	12
Wisconsin	3.50	9	***2.40***	31	4.61	11	12.87	5
Wyoming	***0.00***	50	2.97*	17	5.64	3	13.94	4

NOTE: * indicates tax increase since fiscal 1991; ^ indicates tax decrease since fiscal 1991. Numbers in ***bold italics*** represent taxes that are below average.
SOURCE: Tax revenue: U. S. Census Bureau, *Governmental Finances in 1990-91*; personal income: unpublished data from U. S. Bureau of Economic Analysis (September 2, 1992).

chapter. Classifications below take these recent legislated changes into account, so they differ in some cases from the rankings in Table 8. (Taxes that have been raised by legislation since fiscal year 1991 are indicated by an asterisk.)

- Twenty-one states are below average for the personal income tax: Alabama, Alaska, Arizona, Connecticut, Florida, Illinois, Kansas, Louisiana, Mississippi, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Dakota, Rhode Island, South Dakota, Tennessee, Texas, Washington, and Wyoming.
- Twenty-two states are below average for the sales tax: Alaska, Delaware, Idaho, Illinois, Iowa, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Montana, New Hampshire, New Jersey, North Carolina, Ohio, Oregon, Pennsylvania, Rhode Island, Vermont, Virginia, and Wisconsin.
- Twenty-six states are below average for the property tax: Alabama, Arkansas, California, Delaware, Georgia, Hawaii, Idaho, Indiana, Kentucky, Louisiana, Maryland, Mississippi, Missouri, Nevada, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, Utah, Virginia, Washington, and West Virginia.

With only two exceptions,[64] every state is below average on at least one of the three major taxes. Twenty states are below average for two of the three major taxes (Alabama, Alaska, Delaware, Idaho, Illinois, Kentucky, Louisiana, Maryland, Mississippi, Nevada, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Pennsylvania, Rhode Island, Tennessee, Virginia, and Washington). Twenty-eight states are below average for one tax, and not a single state is below average for all three taxes.[65]

Two words of caution are necessary about interpreting Table 8. First, in some states, revenue per $100 of personal income is inflated because the tax base is unusually large due to greater than average ability to export tax burdens. In Florida, Hawaii, and Nevada, for example, sales tax revenue in part reflects payments by tourists.

Second, there is nothing magical about the national average. Although it has been used in this booklet as a convenient benchmark for comparing the tax systems of different states, it should not be overemphasized. For one thing, there are several different ways of calculating the average, and a state may be above average on one measure and below average according to another. In addition, while keeping tax rates competitive with those of other states is important, other considerations discussed in Chapter 4 also need to be taken into account.

Personal Income Tax Rates

Table 4 shows the top marginal income tax rate in each state as of January 1994. The marginal tax rate is the tax on the last dollar of taxable income received. It is always considerably higher than the average tax rate, which is calculated by dividing total income tax payments by total personal income. (The average income tax rate is used in Table 8).

There are two reasons why the average tax rate is less than the marginal tax rate: some income is not taxed at all because it is exempt[66] or because of deductions, personal exemptions, and tax credits; and most states tax a portion of taxable income at a lower rate than the last dollar of income received. For example, in California, the marginal tax rate for income over $414,000 is 11 percent, but the average tax rate for all income is about 3 percent.

Table 4 shows not only the top marginal tax rate but also the taxable income level at which it goes into effect. If that income level is relatively low, the average tax rate tends to be higher because more income is taxed at the top rate. But the income tax tends to be less progressive because everyone above that income level is taxed at the same rate.

For example, in Kentucky the top rate is 6 percent

[64] These two states differ considerably. Colorado was just slightly above average on each of the three major taxes, but its total tax burden was below average because its revenue from other taxes was much lower than that produced in most other states. For example, its corporation income tax revenue was the lowest in the country among the states that impose this tax. New York, on the other hand, was far above average for both the personal income and the property tax and only slightly above average for the sales tax. Its overall tax revenue per $100 of personal income was the second highest in the United States, and the tax burden on residents was the highest. In Alaska, where revenue per $100 of personal income is higher, most of the tax burden is exported to nonresidents through taxes on oil companies.

[65] In fiscal year 1991, Pennsylvania was below average for all three major taxes, but it was only one cent per $100 of personal income below average for personal income taxes. When the income tax increase enacted in 1991 took effect, Pennsylvania was no longer below average for state-local personal income taxes. However, included in income tax revenue is a substantial amount of local revenue from payroll taxes. For the state personal income tax alone, Pennsylvania is now about average, since its tax rate has increased from 2.1% to 2.8%.

[66] Personal income includes fringe benefits such as employer-paid health insurance and pensions, as well as employee contributions for retirement programs for which taxes are deferred. Thus, considerably more income is exempt than taxpayers may realize when they consider how much of their income is taxed.

on all income above $8,000. This produces much more revenue than if the 6 percent rate took effect at a higher income level, such as $50,000. But Kentucky's income tax is not much more progressive than a flat tax if the tax liability of a middle income family is compared to the taxes paid by an affluent family.

Table 4 also shows that most states have tax rates that reach no higher than 8 percent. In fact, only 10 states have a tax rate that high (California, Hawaii, Idaho, Maine, Minnesota, New Mexico, North Carolina, Oregon, Rhode Island, and Vermont).[67] Considerable uncertainty exists about whether high income tax rates are harmful to economic development,[68] but most states have such low rates that they have considerable room to increase them without imposing burdens that are much higher than those imposed in the average state.

Most states also have considerable latitude to make their income taxes more progressive. This can produce more revenue immediately and faster revenue growth in the future. Increasing progressivity is also attractive because it helps to make the entire tax system fairer. Most states have regressive tax systems because of their heavy reliance on sales and excise taxes. Making the income tax more progressive tends to offset this regressivity.

Increasing the progressivity of the personal income tax is a particularly strong option in 21 of the 41 states with broad-based income taxes:

- *States where all income is taxed at the same rate,* of which there are eight—Colorado, Connecticut, Illinois, Indiana, Massachusetts,[69] Michigan, Montana, and Pennsylvania.
- *States where the top tax rate goes into effect at taxable income of $25,000 or less,* of which there are 13—Alabama ($6,000), Arkansas ($25,000), Georgia ($10,000), Idaho ($20,000), Kentucky ($8,000), Mississippi ($10,000), Missouri ($9,000), Oklahoma ($9,950), Oregon ($10,000), South Carolina ($10,800), Utah ($7,500), Virginia ($17,000), and Wisconsin ($20,000).

[67] This tally does not include Iowa because by allowing federal taxes to be deducted in calculating state taxable income, it effectively makes its tax rates much lower than they appear in nominal terms.

[68] See research on this issue by Wasylenko, Bartik, and others cited in Chapter 5.

[69] Income from capital is taxed at a higher rate than labor income in Massachusetts, but both kinds of income are taxed at a flat rate. The result is to make the income tax somewhat progressive because high-income people receive a higher proportion of their total income from capital.

Other Personal Income Tax Provisions

States have a number of other options available for raising personal income tax revenue and perhaps also increasing progressivity. This section is divided into three parts: exclusions of pension income; indexation; and methods of increasing progressivity without increasing tax rates.

Taxation of pensions

State taxation of pensions varies considerably. Some states have generous exclusions for all pension income, others limit the exclusions to government workers, and others treat pensions the same as other income.[70] Seven states have generous provisions for private pensions, including three states (Hawaii, Mississippi, and Pennsylvania) where all pensions are exempt (see Table 5). In addition, many other states have more limited exclusions (e.g., $2,000 or $6,000 per year), and most states exclude a limited amount of the pensions of government employees. As discussed in Chapter 5, most states also allow a full exclusion for Social Security income, unlike the federal government, which limits the exclusion for high income individuals and couples.

Pension exclusions can be criticized not only because they reduce tax revenue but also because they violate horizontal equity. In some states, a pensioner may pay considerably less income tax than a worker with the same income. Because their tax rate is higher, the value of an exclusion is worth considerably more to pensioners with high income than to those with low income, who may not have to pay the income tax even if pensions were not exempt. Some states reduce that problem by phasing out the benefit of the exclusion as the total income of taxpayers increases.

Many states treat pensions differently depending on their source. Government pensions often receive more favorable treatment than private pensions, and military pensions are sometimes taxed differently from other government pensions. Excluding the pensions of government employees has sometimes been used as a method of enhancing their compensation without immediate sacrifice of revenues, but it has the serious drawback mentioned above: the exclusion is worth more to some retirees than others depending on their tax rate. Thus, an affluent retiree saves more from a pension exclusion than

[70] Technically, when a type of income is not subject to taxation, it is said to be *excluded* from income. The term *exemption* refers to a personal exemption or a dependent exemption, which is a fixed amount that is subtracted from income to recognize that ability to pay depends in part on family size.

a retiree with lower income, because the affluent retiree usually is in a higher tax bracket.

Indexation

States can increase revenue by reducing or eliminating the extent to which they index various provisions of their income tax. States that base their tax code directly on the federal income tax in some cases automatically are indexed. This includes North Dakota, Rhode Island, and Vermont, where the state tax is a percentage of federal tax liability, and Colorado, Idaho, Minnesota, and North Carolina, where state taxable income is the same as federal taxable income. In addition, nine other states have a degree of indexing:[71]

- Iowa: standard deduction and income brackets
- California, Maine, and South Carolina: personal exemptions (or credits) and income brackets
- Arizona, Nebraska, and Oregon: personal exemptions or credits only
- Montana: personal exemptions, standard deduction, and income brackets
- Utah: standard deduction

Methods of increasing progressivity

There are a number of ways for states to increase progressivity without making nominal tax rates more progressive.[72] If these provisions are limited to taxpayers with very high incomes, they have relatively limited potential for raising revenue.

- *Repeal the deduction for federal income tax payments.* This is particularly important in the three states that still allow this deduction in full (Alabama, Iowa, and Louisiana).
- *Repeal the deduction for state income tax payments.* This deduction is allowed only in nine states—Arizona, Georgia, Hawaii, Louisiana, New Mexico, Oklahoma, and the three states that piggyback on federal income tax liability, North Dakota, Rhode Island, and Vermont.
- *Phase out personal exemptions or credits at high income levels.* This is done in 11 states, 9 of which base their tax on federal taxable income or federal tax liability. California has its own phaseout provision, which applies only at a very high income level. Montana also phases out personal exemptions.
- *Phase out the standard deduction.* This is done in Connecticut and Wisconsin.
- *Phase out itemized deductions.* This is done by all states that permit itemized deductions, usually by conforming to the federal provision that takes away $1 of itemized deductions for every $3 of adjusted gross income over $100,000 (up to 20% of all itemized deductions). California and New York, however, have their own phaseouts, which take away more deductions than the federal income tax does.
- *Recapture the benefit of low tax rates below the level of income at which the top tax rate takes effect.* This is done only by the federal government and New York. In New York, taxpayers with income over $150,000 pay the top rate of 7.785 percent on all of their income. The benefit of lower tax rates is gradually taken away for returns with income over $100,000.
- *Impose an alternative minimum tax.* This is done by 11 states (California, Colorado, Iowa, Maine, Minnesota, Nebraska. New York, North Dakota, Rhode Island, Vermont and West Virginia). This provision assures that affluent taxpayers pay a certain proportion of income in tax even if they take heavy advantage of provisions that shelter income from taxation.

Sales Tax Coverage

Table 9 shows the state sales tax rate and the typical state-local sales tax rate and whether the state exempts food, residential utilities, and clothing. Twenty-five states exempt food, 29 exempt residential utilities to some extent, and 6 exempt clothing.

Table 6 shows how many services were covered by the sales tax as of November 1992. Twenty-four states have the narrowest taxation of services, covering 50 or fewer services: Alabama, California, Colorado, Georgia, Idaho, Illinois, Indiana, Kentucky, Maine, Maryland, Michigan, Missouri, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Carolina, Utah, Vermont, and Virginia.

[71] The description of indexation provisions is taken from *Significant Features of Fiscal Federalism*, p. 54-57, with some states reclassified to include more current information.

[72] For further discussion of most of these methods, see Iris Lav, *Taxing the Top* (Washington, D. C.: Center on Budget and Policy Priorities, 1992).

Table 9. Rates and Exemptions of State Sales Taxes, July 1993

	Tax Rates		Exemption		
	State	Combined State-Local	Food	Utilities	Clothing
Alabama	4.0%	6 to 9%		Y	
Alaska	—	— — —			
Arizona	5.0	6.5 to 7	Y		
Arkansas	4.5	5.5 to 6.5			
California	6.0	7.25 to 8.25	Y	Y	
Colorado	3.0	6 to 7.5	Y	Y	
Connecticut	6.0	6	Y	Y	Y
Delaware	—	— — —			
Florida	6.0	6 to 7	Y	Y	
Georgia	4.0	5 to 6			
Hawaii	4.0	4		Y	
Idaho	5.0	5		Y	
Illinois	6.25	6.25 to 8.75	Limited		
Indiana	5.0	5	Y		
Iowa	5.0	5 to 6	Y		
Kansas	4.9	5.9 to 6.9		Y	
Kentucky	6.0	6	Y	Y	
Louisiana	4.0	6.25 to 10	Limited		
Maine	6.0	6	Y	Y	
Maryland	5.0	5	Y	Y	
Massachusetts	5.0	5	Y	Y	Y
Michigan	4.0	4	Y		
Minnesota	6.0	6.5 to 7.5	Y		Y
Mississippi	7.0	7		Y	
Missouri	4.225	5.725 to 7.225		Y	
Montana	—	— — —			
Nebraska	5.0	6.5	Y		
Nevada	6.5	7	Y	Y	
New Hampshire	—	— — —			
New Jersey	6.0	6	Y	Y	Y
New Mexico	5.0	5.8125 to 6.25			
New York	4.0	7 to 8.5	Y	Y	
North Carolina	4.0	6			
North Dakota	5.0	5.5	Y	Limited	
Ohio	5.0	5 to 7	Y	Y	
Oklahoma	4.5	4.5 to 8.5		Y	
Oregon	4.5	4.5		Y	
Pennsylvania	6.0	6 to 7	Y	Y	Y
Rhode Island	7.0	7	Y	Y	Y
South Carolina	5.0	5 to 6		Y	
South Dakota	4.0	6			
Tennessee	6.0	7.75 to 8.5		Y	
Texas	6.258	7.25 to 8.25	Y	Y	
Utah	5.0	6.25		Limited	
Vermont	5.0	5	Y	Y	
Virginia	3.5	4.5		Y	
Washington	6.5	7.8 to 8.2	Y	Y	
West Virginia	6.0	6		Y	
Wisconsin	5.0	5 to 5.5			
Wyoming	4.0	6			

SOURCE: U. S. ACIR, *Significant Features of Fiscal Federalism, 1993 Edition*, vol. 1, p. 96-113.

Table 10. State Lottery Revenue, 1991

	Per Capita	Rank	Percent of tax revenue
National average	***$40.74***		***3.16%***
Arizona	22.92	20	1.82
California	25.50	17	1.73
Colorado	16.67	23	1.75
Connecticut	60.10	5	3.97
Delaware	37.15	13	2.17
Florida	64.34	4	6.21
Idaho	15.57	24	1.34
Illinois	50.59	8	4.39
Indiana	26.95	16	2.45
Iowa	13.69	28	1.11
Kansas	8.87	31	0.79
Kentucky	14.65	26	1.08
Maine	27.85	15	2.21
Maryland	68.98	2	5.24
Massachusetts	78.46	1	4.86
Michigan	45.81	10	3.87
Minnesota	14.88	25	0.94
Missouri	12.68	29	1.31
Montana	5.52	32	0.55
New Hampshire	30.67	14	5.43
New Jersey	67.83	3	4.52
New York	52.31	7	3.34
Ohio	58.10	6	5.50
Oregon	12.41	30	1.20
Pennsylvania	50.30	9	4.62
Rhode Island	24.75	18	1.98
South Dakota	41.80	11	5.56
Vermont	22.25	21	1.84
Virginia	41.18	12	3.78
Washington	19.67	22	1.24
West Virginia	13.76	27	1.06
Wisconsin	24.42	19	1.72

NOTE: Revenue excludes prizes and administrative costs.
SOURCE: U.S. Census Bureau, *State Government Finances in 1991.*

State Revenue from Gambling

People often exaggerate the revenue states derive from gambling. For example, the 32 state lotteries operating in 1991 produced $7.6 billion of net revenue. This represented less than 3.2 percent of their state tax collections that year. The amounts raised by lotteries sound huge to the uninitiated, but they are fairly small compared to the amounts of money that states spend. (Incidentally, by mid-1993, the number of states with lotteries had grown to 37.)

Part of the confusion arises from the difference between gross and net revenue. In 1991, state lottery sales were $19.2 billion. But $10.4 billion was paid out in prizes and $1.2 billion went for administration, leaving the $7.6 billion mentioned above. In other words, only 40 percent of lottery sales were available for state programs after paying out prizes and covering administrative costs.

Table 10 shows lottery revenue available for state programs in 1991 in relation to a state's population and its total tax revenue. Massachusetts had the highest lottery revenue per capita, $78. The lottery produced more than $50 per capita in eight other states (Connecticut, Florida, Illinois, Maryland, New Jersey, New York, Ohio, and Pennsylvania).

Lottery revenue as a proportion of total state tax revenue was highest in Florida and South Dakota, approximately 6 percent in both cases. Both of these states have relatively low tax revenue. Florida benefits from lottery purchases by tourists, while South Dakota was the national pioneer in allowing widespread video lotteries (which are really electronic slot machines rather than lotteries in the traditional sense).

Lotteries do look big compared to the revenue states receive from pari-mutuel taxes. In 1991, revenue from that source was only $635 million. This was 3.5 percent less than the year before, which in turn was 1.2 percent less than pari-mutuel revenue in 1989.

What about casinos? Nevada's gambling and casino entertainment taxes in 1991 produced $348 million, along with another $57 million from licenses for slot machines and other games. These taxes brought in about 24 percent of Nevada's tax revenue. When other taxes related to gaming and the tourism it produces are counted, gambling accounts for about half of Nevada's state tax revenue. But Nevada is unique. It combines a small population with a huge gambling industry. Gambling cannot have nearly as much impact on state finances in any other state.

Consider, for example, New Jersey, where the state's take in 1991 was $246 million in casino gross revenue taxes, along with another $50 million from licenses for casinos and slot machines. New Jersey's total state tax revenue was $11.6 billion, so these taxes and licenses were only about 2.5 percent of total state tax revenue.

School Revenue

The property tax is overwhelmingly the source of local school tax revenue. In 1990, it accounted for 97.4 percent of local tax revenue in the 41 states where there are at least some independent school districts. Among these states, there were only four where the property tax generated less than 98 percent of local tax revenue:

- In Louisiana, 55.1 percent of local tax revenue came from the sales tax, only 44.7 percent was from the property tax, and 0.2 percent was from miscellaneous taxes.
- In Kentucky, 66.0 percent came from the property tax, 15.8 percent came from the income tax, 11.4 percent from utility taxes, and 6.8 percent from miscellaneous taxes.
- In Pennsylvania, 83.0 percent was from the property tax, 9.7 percent came from the income tax, and 7.4 percent from miscellaneous taxes.
- In South Dakota, the property tax produced 95.6 percent of local tax revenue, the sales tax contributed 3.0 percent, and miscellaneous taxes, 1.3 percent.

Use of non-property taxes by independent school districts can be summarized as follows:

- *Income tax*: 4 states—Iowa (0.3%), Kentucky (15.8%), Ohio (less than 0.1%), and Pennsylvania (9.7%).
- *Sales tax*: 2 states—Louisiana and South Dakota, as described above.
- *Utility tax*: 3 states—Kentucky, Nevada (0.5%), and New York (0.2%).
- *Miscellaneous taxes*: 19 states. Except in Kentucky and Pennsylvania (described above), their biggest contribution was in Mississippi (1.6%).

In addition, there are 9 states with no independent school districts and 5 states where at least some school districts are not independent. For example, in Maryland and Virginia the schools are financed by counties and cities, in Connecticut and Massachusetts by cities and towns, and in Hawaii by the state government. Where cities and counties have access to sales and income taxes, it is impossible to determine what proportion of the school district budget is derived from the income tax, the sales tax, other non-property taxes, or the property tax, since these tax revenues become part of the general funds of the city or county.

Appendix to Chapter 8. Recent State Tax Legislation

Recent tax legislation affected personal income or general sales taxes in many states. In general, legislation is referred to by the calendar year in which it was enacted. The full effect of the tax change is not felt until the following fiscal year or sometimes later:

Arizona: A 1990 personal income tax increase was in effect for only half of fiscal year 1991. Even with that increase, income tax revenue per $100 of personal income is below average. A reduction was enacted in 1994.

Arkansas: A 1991 sales tax increase made it even further above average than it was in fiscal year 1991.

California: 1991 increases in the sales and income taxes made the tax system even less balanced than it was previously.

Colorado: A relatively small 1992 income tax increase (repeal of the deduction for state income taxes) made the income tax slightly more above average than it was.

Connecticut: As a result of the 1991 tax reform, the state income tax is now above average. However, since there are no local income taxes in Connecticut, the average tax rate on personal income is close to the national average for combined state and local income taxes. The sales tax is now below average.

Iowa: Despite a 1992 sales tax increase, its revenue per $100 of personal income is still somewhat below average.

Kansas: 1992 increases in the sales and income tax moved those taxes closer to the national average, with the sales tax slightly above and the income tax somewhat below average.

Kentucky: The 1990 income tax increase was not fully reflected in fiscal year 1991. Note that the high income tax revenue per $100 of personal income in part reflects heavy reliance on local payroll taxes.

Maine: Despite a 1991 sales tax increase, that tax's revenue per $100 of personal income was still somewhat below average. A 1991 income tax increase has expired.

Maryland: Despite sales tax base broadening, especially in 1992, that tax's revenue per $100 of personal income is still below average.

Massachusetts: Despite the phaseout of a temporary income tax increase, that tax is still above average.

Minnesota: Despite a 1991 one-half cent sales tax rate increase, that tax's revenue per $100 of personal income is still below average.

Mississippi: A small 1992 income tax increase (repeal of the deduction for state income tax payments) left that tax well below average. The 1992 sales tax increase made that tax even further above average.

Missouri: The 1993 income tax increase makes state-local income tax revenue somewhat above average. If local payroll taxes in St. Louis and Kansas City are excluded, tax revenue per $100 of personal income is close to average.

Montana: A 1993 income tax increase would make that tax more above average than it was, but it has been suspended pending a November 1994 referendum.

Nebraska: A 1990 income tax increase was not fully reflected in fiscal year 1991. It makes income tax revenue per $100 of personal income close to the national average.

Nevada: A 1991 sales tax increase made that tax even further above average than it was previously.

New Jersey: The 1990 personal income tax increase was not fully reflected in fiscal year 1991. Even with that increase, revenue per $100 was below average. The personal in-

come tax rates were reduced in 1994. The sales tax is further below average than in fiscal year 1991 because the 1990 increase was repealed in 1992.

North Carolina: A 1991 sales tax increase moved that tax closer to the national average, but it is still below it. A small income tax increase moved that tax further above average.

Ohio: Small 1992 personal income and sales tax increases did not have major effects on relative levels of revenue from those taxes.

Oklahoma: A 1990 income tax increase was not fully reflected in fiscal year 1991.

Pennsylvania: A large 1991 income tax increase moved income tax revenue per $100 of personal income above the national average, if local payroll taxes are included. The state income tax alone is close to the national average for state income taxes. Despite sales tax base broadening in 1991, that tax's revenue per $100 of personal income remains considerably below the national average.

Rhode Island: Income tax increases in 1991 and 1992 moved that tax close to the national average if not somewhat higher, but they have expired.

Tennessee: A 1992 sales tax increase made that tax even further above average than it was previously.

Vermont: The 1991 income tax increase has expired.

Wyoming: A 1993 sales tax increase made that tax even further above average than it was previously.

Chapter 9
Earmarking

Earmarking for education is widespread. In fact, a majority of states earmark some state tax revenue for schools. Education also receives earmarked revenue from about a third of state lotteries. Earmarking has a superficial appeal for school advocates because the public is more supportive of a tax increase or a lottery if the money from it is dedicated to a popular program, such as education. But earmarking is not an unmixed blessing. Its benefits for education are usually exaggerated.

Despite the proliferation of earmarking, its fiscal effects are not straightforward. In many cases, the intent of earmarking may be circumvented by reducing state support from nonearmarked revenues, resulting in no increase in the share of state or local funds going to education.

Extent of Earmarking for Education

As of 1988, a survey by the National Conference of State Legislatures found that at least 28 states earmarked at least one tax for education.[73] The taxes most frequently earmarked were the general sales tax (11 states), the severance tax (7 states), and tobacco taxes (7 states). Other taxes earmarked in at least 4 states were those on property (5 states), alcoholic beverages (4 states), personal income (4 states), public utilities (4 states), corporate income (4 states), and insurance premiums (4 states).

As discussed in Chapter 8, the mainstays of state tax systems are the personal income, general sales, and corporation income taxes. Eight states earmarked at least a quarter of one of these taxes for education:

- *General sales*: Alabama (89%), Michigan (60%), Nevada (26%), South Carolina (100%), Tennessee (65%), and Virginia (33%)
- *Personal income*: Alabama (97%), New Jersey (100%, including some for property tax relief), Montana (31%), and Utah (100%)
- *Corporation income*: Alabama (100%) and Utah (100%)

In addition, 12 states earmark lottery revenue for education (California, Florida, Idaho, Illinois, Indiana, Michigan, Montana, New Hampshire, New Jersey, New York, Ohio, and West Virginia). In California and New Jersey, some of the revenue is shared with higher education, but usually it is solely for elementary and secondary schools.

Effects of Earmarking[74]

All money is green. That statement gets at one of the main truths about the impact of earmarking. To the uninitiated, a $100 million tax increase permanently earmarked for schools will result in education receiving $100 million more state support than it would have otherwise, on a continuing basis. Anyone adhering to that view would almost certainly be wrong.

Let's consider a hypothetical $100 million tax increase that is earmarked for Program X, which is not necessarily education. There are three possible scenarios:

(1) Program X would not have received any money without the earmarked funds.

(2) Program X would have received $60 million without the earmarked funds.

[73] Martha A. Fabricius and Ronald K. Snell, *Earmarking State Taxes*, 2nd ed. (Denver: National Conference of State Legislatures, 1990). Findings were summarized in Education Earmarking Likely to Continue, *The Fiscal Letter* (July/August 1990), p. 2-4.

[74] This analysis is drawn from Steven D. Gold, Brenda Erickson, and Michelle Kissell, *Earmarking State Taxes* (Denver: National Conference of State Legislatures, 1986).

(3) Program X would have received $1 billion without the earmarked funds.

In the first scenario, Program X clearly benefits by the full amount of the earmarking, since its budget goes from zero to $100 million. In the second scenario, Program X benefits by at least $40 million, since that is the excess of the earmarked funds over what it would otherwise have received. In the third scenario, there is no assurance that Program X will benefit at all. Policymakers could subtract $100 million from the allocation to Program X from general revenue, leaving Program X with no more money than it would have had if there were no earmarking.

Elementary-secondary education is virtually always in a situation like the third scenario. States normally provide so much aid to schools in any case that earmarked revenue is almost certain to be far less than the schools would otherwise receive.[75] Viewed narrowly, there is no guarantee that earmarking boosts the aid for schools under most circumstances.

There are at least six more points to be made that expand this analysis of earmarking:

1. Earmarking often makes it feasible to raise total state revenue to a higher level than it would be otherwise because citizens are more willing to support tax increases or lotteries if they approve of the advertised use of the revenue they produce. Because elementary-secondary education is such a large part of state budgets, it normally receives a significant share of incremental state revenue. So even though earmarking does not *guarantee* that schools receive all of the benefit from a tax increase or lottery, they usually receive a sizable share of it. In other words, earmarking expands the pie, and schools get a big slice.

2. When first adopted, an earmarking provision may cause spending for the designated program to increase because of the publicity attendant on enactment of the earmarking, but over time the earmarked revenue may have less effect on spending levels as the spotlight moves to other areas. Because inflation normally causes spending to rise year after year, it is difficult to trace the effects of earmarking in the years after it is first implemented.

3. Earmarking provisions may supposedly require that a state continue to at least spend whatever it was spending before earmarking began. Those requirements are usually ineffective because inflation leads to higher outlays over time, so there is no way of knowing whether spending is any higher because of earmarking than it would be otherwise.

4. Earmarking may be viewed as committing the state to increase spending in a certain area, so it could strengthen the arguments of advocates even though it is technically possible to avoid such action.

5. Earmarking in some cases may actually *decrease* total spending for a program because it creates a false impression that the program has plenty of funds. It is said, for example, that "schools don't need more tax money because they're getting so much from the lottery." The public often has an exaggerated impression of the relative size of the revenue generated by lotteries.

6. The skeptical conclusions about the efficacy of earmarking do not apply to measures like California's Proposition 98, which earmarks a proportion of total state general revenue for schools and requires that education receive a significant share of revenue increases. It is much more difficult to subvert a provision guaranteeing a share of *total* state revenue than one that earmarks a *single tax*.[76]

To summarize, the effects of earmarking are complex. It is unlikely to increase the share of the budget going to education over the long run, but it may boost the priority of education spending for a few years immediately after it is enacted. Moreover, earmarking often increases the total resources available to state government because it makes it more feasible to increase tax rates. Thus, even though earmarking may not affect education's share of the state budget, schools benefit because the budget has expanded. When the state budget grows, education is usually a major beneficiary.

[75] Alabama and New Hampshire are possible exceptions. In Alabama, schools receive 90% of the sales tax and 100% of the personal and corporation income taxes. This high degree of earmarking may produce more than education would otherwise receive. In New Hampshire, on the other hand, state school aid is so low that if a new broad-based tax were enacted, it would easily be possible for it to provide more than local schools currently receive in state aid.

[76] Even Proposition 98 has been undermined to some extent. In 1991, for example, a half-cent state sales tax increase for local health programs was dedicated to a special fund outside of the general fund. Proposition 98 applies only to general fund revenue.

Conclusion

As a political strategy, it often makes sense to earmark revenue increases because that enhances the political feasibility of increasing taxes. But it should be understood that normally education will not really benefit by the full amount of the tax increase. In any case, the potency of earmarking as a help in selling a tax increase is likely to wane over time as the public becomes more cynical about it. If many people are disillusioned by a recent experience with earmarking, they are much less likely to be swayed by it again.

Advocates should also be wary of the potential for a "war of the earmarks." Proponents of social services, transportation, environmental initiatives, and other programs may also fight for earmarked revenues. To the extent they succeed, education may be a loser.

Chapter 10
Revenue Opportunities for Each State

This book has laid out a wide variety of options for states seeking more revenue for schools. This chapter highlights the most important options for each state. Obviously many other options are also available for most states. Most could, for example, increase the progressivity of their income taxes; this option has been omitted here for the states that already have relatively progressive income taxes. (Income levels referred to below are for married couples filing jointly.) Most states also could broaden their income tax base by treating retirement income as the federal goverment does, rather than giving it preferential treatment.

The most common option listed below is to expand the taxation of services. This alternative is listed whenever a state sales tax applies to fewer than 80 services. Even states with broader coverage could gain revenue by taxing additional services, but this compilation excludes the six states that already have the broadest sales tax coverage of services.

Many of the options listed here are controversial. The preceding chapters have mentioned some of their drawbacks as well as their advantages. In many situations it would be desirable to combine several of the options, often accompanied by other adjustments discussed in this book. For example, while broadening a tax base, it may be desirable to reduce a tax rate rather than to use all of the additional revenue for spending. Likewise, targeted tax credits might be financed with some of the revenue from a regressive tax increase to offset the burden on low and moderate income households.

Finally, taxes on business, excise taxes, and gambling are generally not discussed, although there is room for getting more revenue in each of these areas in many states. In particular, value added taxes are an attractive option on a broad scale. Rather, this chapter focuses on the potential from the three major taxes—personal income, sales, and property. If substantial, consistently growing revenues are needed, those three taxes are usually the most fruitful areas to consider.

The leading options for increasing school revenue are obvious in the states that do not impose either a broad-based income tax or a general sales tax. There are nine states without an income tax that applies to wages and salaries, interest, dividends, and capital gains; two of these states (New Hampshire and Tennessee) tax some types of non-labor income, but that is no substitute for a broad-based income tax. Five states do not have a general sales tax, including Alaska, where some local governments impose a sales tax.

It should be noted that some of the policies listed below require amending the state constitution. This makes them considerably more difficult to enact than simply having the legislature approve a tax bill, which is no easy feat in itself.

Alabama — The property tax could be increased because it is the lowest in the nation. The relatively low personal income tax could be increased, and its progressivity could be increased considerably because the 5 percent top rate begins at $6,000 taxable income. The generous income tax treatment of pension benefits could be repealed or curtailed. The deduction for federal tax payments could be repealed. The base of the sales tax could be broadened; only 32 services are taxed.

Alaska — A state personal income or general sales tax could be enacted, since this is one of only two states that do not impose either of these taxes.

Arizona — The personal income tax could be increased because its effective rate is below average (even considering the 1990 tax increase, which is only partially reflected in Tables 7 and 8). The deduction for state income tax payments could be repealed, and indexation could be

repealed or curtailed. The base of the sales tax could be broadened; only 60 services are taxed.

Arkansas The personal income tax could be increased; its effective rate is close to the national average. Its progressivity could be increased considerably because the 7 percent top rate begins at $25,000 taxable income. The base of the sales tax could be broadened; only 52 services are taxed.[77] The property tax could be increased; it is among the lowest in the nation.

California The property tax could be increased; it is well below the national average as a result of Proposition 13.* The base of the sales tax could be broadened; only 19 services are taxed. Indexation of the income tax could be repealed or curtailed.*

Colorado The progressivity of the personal income tax could be increased because it is a flat tax, and indexation could be repealed or curtailed. The $20,000 income tax exemption for pension benefits could be repealed or curtailed. The base of the sales tax could be broadened; only 15 services are taxed. The corporation income tax is among the lowest in the nation and could be increased.

Connecticut The progressivity of the personal income tax could be increased because it is a flat tax.

Delaware A general sales tax could be enacted, since this is one of only five states that do not impose one. The progressivity of the personal income tax could be increased; the 7.7 percent top rate begins at $40,000 income. The property tax is one of the lowest in the nation and could be increased.

Florida A personal income tax could be enacted, since this is one of only nine states that do not impose this tax. The property tax homestead exemption ($25,000) could be reduced. (This reduction could either be across the board or it could phase out benefits at high income levels.) The base of the sales tax could be broadened because only 65 services are taxed.

Georgia The progressivity of the personal income tax could be increased considerably because the top rate is only 6 percent and it begins at $10,000 taxable income. The deduction for state income tax payments could be repealed. The base of the sales tax could be broadened; only 35 services are taxed. The below average property tax could be increased.

Hawaii The property tax could be increased because it is one of the lowest in the nation. The deduction for state income tax payments could be repealed. The full income tax exemption of pension benefits could be repealed or curtailed, and indexation could be limited.

Idaho The base of the sales tax could be broadened; only 29 services are taxed. Sales tax revenue is below average relative to personal income. The relatively low property tax could be increased, for example, by reducing the homestead exemption, which exempts half of the assessed value of homes up to a maximum exemption of $50,000. Income tax indexation could be repealed or curtailed.

Illinois The relatively low personal income tax could be significantly increased. Its progressivity could also be increased because it is a flat tax. The generous income tax treatment of pension benefits could be repealed or curtailed. The sales tax could be increased because it is below average, and its base could be broadened because only 16 services are taxed.

Indiana The progressivity of the personal income tax could be increased; it is a flat tax. The base of the sales tax could be broadened; only 24 services are taxed. The below average property tax could be increased. One approach would be to reduce state-financed credits that cover 20 percent of tax liability for all property and an additional 4 percent for homeowners. (These reductions could occur either across the board or through a phaseout of benefits at high income levels.)

[77] This tally does not consider the services added in December 1992.

*This change requires a constitutional amendment.

Iowa The income tax deduction for federal income tax payments could be repealed, and indexation could be repealed or curtailed. The relatively low sales tax rate could be increased.

Kansas The relatively low personal income tax could be increased. The base of the sales tax could be broadened; only 76 services are taxed.

Kentucky The progressivity of the personal income tax could be increased considerably; the 6 percent top rate begins at $8,000 taxable income. The property tax could be increased; it is one of the lowest in the nation. The relatively low sales tax could be increased, and its base could be broadened because only 26 services are taxed.

Louisiana The personal income tax could be increased because it is one of the two lowest in the nation among states that impose this tax. This increase could involve repeal of the deductions for federal and state income tax payments.* The relatively low property tax could be increased, for example, by reducing the $75,000 homestead exemption.* (This reduction could either be across the board or it could phase out benefits at high income levels.) The base of the sales tax could be broadened; only 53 services are taxed.

Maine The relatively low sales tax could be increased. The base of the sales tax could be broadened; only 27 services are taxed. Indexation of the income tax could be repealed or curtailed.

Maryland The sales tax could be increased because it is relatively low. The base of the sales tax could be broadened; only 36 services are taxed. The relatively low property tax could be increased.

Massachusetts The sales tax could be increased because it is relatively low. The base of the sales tax could be broadened; only 20 services are taxed. The progressivity of the income tax could be increased; it is currently a flat tax.

Michigan The progressivity of the income tax could be increased because it is a flat tax.* The relatively low sales tax rate could be increased,* and its base could be broadened because only 26 services are taxed.

Minnesota The relatively low sales tax could be increased. The base of the sales tax could be broadened; only 61 services are taxed. Indexation of the income tax could be repealed or curtailed.

Mississippi The personal income tax could be increased; it is one of the lowest in the nation among states that impose this tax. The progressivity of the personal income tax could be increased considerably because the 5 percent top rate begins at $10,000 taxable income. The full income tax exemption of pension benefits could be repealed or curtailed. The property tax could be increased; it is one of the lowest in the nation. The base of the sales tax could be broadened; only 69 services are taxed.

Missouri All major taxes are low. The personal income tax could be increased by repealing the remaining deduction for federal personal income tax payments. Its progressivity could also be increased because the 6 percent top rate begins at $9,000 taxable income. The base of the sales tax could be broadened; only 28 services are taxed. The relatively low property tax could be increased.

Montana A general sales tax could be enacted, since this is one of only five states that do not impose one. The progressivity of the personal income tax could be increased because it is a flat tax, and indexation could be repealed or curtailed.

Nebraska The progressivity of the personal income tax could be increased because the top rate is only 6.99 percent, and indexation could be repealed or curtailed. The base of the sales tax could be broadened; only 48 services are taxed.

Nevada A personal income tax could be enacted, since this is one of only nine states that do not impose this tax. It is one of five states without a corporation income tax. The base of the sales tax could be broadened; only 11 services are taxed.

* This change requires a constitutional amendment.

Michigan Update

The *New York Times* called it "the most dramatic shift in a century in the way public schools are financed," but it was merely an example of the kind of reform discussed in this book. In March 1994, Michigan voters approved a plan to cut school property taxes and replace them with a 2-cent sales tax increase, a 50-cent hike in the cigarette tax, and a real estate transfer tax. Their personal income tax was also reduced slightly.

Before 1994, Michigan had an extremely high property tax and a very low sales tax. The 1994 reform will bring both of these taxes fairly close to the national averages, making its tax system much more balanced than it was. In this sense, Michigan's action was hardly revolutionary: it just did what many other states had done years earlier.

While it deserves a good grade for making the tax system more balanced, the Michigan tax reform package had a number of shortcomings:

- Cigarette tax revenue will fall, not increase, in future years.
- Hardly anything was done to broaden the narrow sales tax base or to offset the regressivity of the sales and cigarette tax increases.
- Revenue from the new taxes will fall considerably short of replacing the lost property tax revenue in future years. Initially, Michigan will use a state surplus to fill the gap, but the state will have to either cut spending or increase other taxes eventually.

What are the main lessons for other states? The case for cutting the Michigan property tax was strong because it was so high, but radical cuts in the property tax are not as advisable where it is lower. Although the original goal was to zero out the school property tax for operating expenses, that objective could not be achieved. Bottom line: Michigan took a giant step toward having a balanced tax system, but whether the reform will ultimately be good for schools remains to be seen because the replacement revenue is inadequate to cover future costs.

	The relatively low property tax could be increased.
New Hampshire	A broad-based state personal income tax or a general sales tax could be enacted, since this is one of only two states that do not impose either of these taxes.
New Jersey	The relatively low sales tax could be increased. The base of the sales tax could be broadened; only 45 services are taxed. The personal income tax could be increased because it is also relatively low.
New Mexico	The personal income tax, property tax, and corporation income tax could be increased because they are relatively low. The deduction for state income tax payments could be repealed.
New York	The base of the sales tax could be broadened; only 74 services are taxed. The generous income tax treatment of pension benefits could be repealed or curtailed.
North Carolina	The relatively low property tax could be increased. The sales tax is below average and could be increased. Its base could be broadened; only 29 services are taxed. Indexation of the income tax could be repealed or curtailed.
North Dakota	The personal income tax could be increased because it is one of the two lowest in the nation among states that impose this tax, and indexation could be repealed or curtailed. The base of the sales tax could be broadened; only 21 services are taxed. The below average property tax could be increased.
Ohio	The sales tax could be increased because it is below average, and its base could be broadened; only 42 services are taxed.[78] The relatively low property tax could be increased by reducing state-financed credits that cover 10 percent of tax liability for all property (and an additional 2.5 percent for homeowners). (These reductions could occur either across the board or through a phaseout of benefits at high income levels.)
Oklahoma	The progressivity of the personal income

[78] This tally does not consider the services added in December 1992.

	tax could be increased because the 7 percent top rate begins at taxable income of $9,950. The deduction for state income tax payments could be repealed. The base of the sales tax could be broadened because only 31 services are taxed. The property tax could be increased because it is relatively low.
Oregon	A sales tax could be enacted, since this is one of only five states that do not impose one. The progressivity of the personal income tax could be increased because its 9 percent top rate begins at $10,000 taxable income, and indexation could be repealed or curtailed. The deduction for state income tax payments could be repealed.
Pennsylvania	The personal income tax could be made progressive since it is a flat tax. The full income tax exemption of pension benefits could be repealed or curtailed. The relatively low sales tax could be increased, and its base could be broadened; only 61 services are taxed. The relatively low property tax could be increased.
Rhode Island	The relatively low sales tax could be increased, and its base could be broadened; only 28 services are taxed. Indexation of the income tax could be repealed or curtailed.
South Carolina	The base of the sales tax could be broadened; only 32 services are taxed. The relatively low property tax could be increased. The progressivity of the personal income tax could be increased because its 7 percent top rate begins at $10,800 taxable income, and indexation could be repealed or curtailed.
South Dakota	A personal income tax could be enacted, since this is one of only nine states that do not impose this tax. A corporate income tax could be enacted, since this is one of only four states that do not impose such a tax.
Tennessee	A broad-based personal income tax could be enacted, since this is one of only nine states that do not impose a broad-based one. The property tax could be increased because it is relatively low. The base of the sales tax could be broadened; only 70 services are taxed.
Texas	A personal income tax could be enacted, since this is one of only nine states that do not impose this tax. The base of the sales tax could be broadened; only 79 services are taxed.
Utah	The base of the sales tax could be broadened because only 49 services are taxed. The progressivity of the personal income tax could be increased because the 7.2 percent top rate begins at $7,500 taxable income, and indexation could be repealed or curtailed. The deduction for half of federal tax payments could be repealed. The relatively low property tax could be increased.
Vermont	The sales tax could be increased because its revenue is low and its base is particularly narrow. Only 23 services are taxed. Indexation of the income tax could be repealed or curtailed.
Virginia	The sales tax could be increased because its revenue is relatively low and only 18 services are taxed. The income tax could be made more progressive since its 5.75 percent top rate begins at $17,000. The relatively low property tax could be increased.
Washington	A personal income tax could be enacted, since this is one of only nine states that do not impose a this tax. The property tax could be increased; it is below average.
West Virginia	The property tax could be increased; it is much lower than in most other states. The personal income tax could be increased because its burden is about average and its highest rate is only 6.5 percent.
Wisconsin	The sales tax could be increased because revenue is considerably less than in the average state. Its base could be broadened; only 69 services are taxed. The progressivity of the personal income tax could be increased; its 6.93 percent top rate begins at $20,000 taxable income.
Wyoming	A personal income tax could be enacted, since this is one of only nine states that do not impose this tax. In fact, the sales tax and property tax are also lower than in the average state. The base of the sales tax could be broadened; only 64 services are taxed.

Glossary

Ability-to-pay principle. The idea that tax liability should be based on a household's economic well-being, usually as measured by income or wealth. This is distinguished from the benefit principle of taxation.

Adjusted gross income. Total income subject to tax after subtracting certain outlays, such as contributions to individual retirement accounts. This is a broader measure of income than taxable income, which reflects the subtraction from adjusted gross income of personal exemptions and deductions.

Assessed value. The value used for the purpose of determining property tax liability. It can be distinguished from the market value of property, which is usually higher.

Average tax rate (of income tax). The amount of tax paid divided by total household income; this is distinguished from the marginal tax rate, which is the tax rate on the last dollar earned. Except for a flat rate tax with no exemptions, deductions, or credits, the average tax rate is always less than the marginal tax rate.

Benefit principle. The idea that taxes should be based on the benefits received by a household rather than its ability to pay.

Circuit breaker. A form of residential property tax relief. It is a tax credit the value of which depends on a household's income and property tax payments. The lower the income and the higher the property tax paid, the larger the tax credit. Usually renters are eligible along with homeowners, with a certain portion of rent assumed to represent property tax payments.

Competitiveness. The idea that a state or locality should have low tax rates and high services to make itself an attractive place for businesses to invest.

Credit. An amount that is subtracted from tax liability. For an income tax, this is distinguished from a deduction, which is subtracted in the process of calculating how much income is subject to tax. Credits are usually applied to either income tax or property tax liability.

Deduction. An expenditure that can be subtracted in calculating the amount of income subject to taxation. This is distinguished from an exclusion, which is a kind of income that is not taxed, and an exemption, which is a certain amount per person that is subtracted in determining taxable income. There are two kinds of deductions, itemized and standard deductions.

Earmarking. The dedication of a stream of revenue on a continuing basis to a particular program or government agency.

Effective tax rate. For the income tax, tax liability as a percentage of total income. For the property tax, tax liability as a percentage of the market value of property.

Efficiency. The allocation of resources to the point that marginal social benefits and marginal social costs are equal.

Elasticity. A measure of the responsiveness of a single tax or the entire tax system to economic growth, measured as the percentage change of tax revenue resulting from a 1 percent change in personal income. (To calculate elasticity, the effect of legislated changes in tax rates and bases must be eliminated.) This concept is technically referred to as *income elasticity.* It can be distinguished from *price elasticity*, which refers to the percentage change of quantity resulting from a 1 percent change in price.

Excise tax. A sales tax that applies to purchases of a particular good or service, such as a tax on motor fuels or cigarettes. It is distinguished from a general sales tax that applies broadly to purchases of tangible personal property and selected services.

Exclusions. Income tax provisions that allow certain kinds of income to escape taxation. Examples of excluded income are welfare benefits and most interest on municipal bonds.

Exemptions (property tax). Amounts that are subtracted from the assessed value of a property in calculating the tax base to which the tax rate is applied.

Exemptions (sales tax). Goods and services that are not subject to the sales tax.

Exemptions (income tax). See personal exemptions.

Exportability. The ability to shift the burden of a tax so that it does not fall on residents of the jurisdiction imposing the tax. Taxes can be exported directly, for example, by having tourists pay a sales tax, or through the federal tax code. When income and property taxes are deducted in computing federal income tax, this results in lower federal tax payments, which means that part of the burden is exported to the federal treasury.

Gross receipts tax. A tax that is applied to all sales of a company (with some possible exemptions). It is distinguished from a value added tax, which applies to all sales minus purchases from other firms.

Horizontal equity. The idea that people or businesses that are equally well off should pay the same tax.

Impact. The locus of the initial burden of a tax, as distinguished from its incidence, which refers to where the burden lies after the tax may be shifted.

Incidence. The locus of the ultimate burden of a tax after it has been shifted. For example, in some cases the impact of a tax may be on a business, which may be able to shift the incidence of the tax to consumers or suppliers, including its employees.

Indexation. The adjustment of income tax provisions that are specified in dollar terms to eliminate the effect of inflation. It may apply to tax brackets, personal exemptions, credits, and deductions.

Inefficiency. The misallocation of resources resulting from distortions caused by a tax. For example, a tax may cause some economic activity to move from one jurisdiction to another, or it may influence how businesses purchase inputs or consumers purchase outputs.

Itemized deduction. An expenditure that can be subtracted in the calculation of income subject to taxation. Examples are mortgage interest and charitable contributions.

Marginal tax rate. The amount of income tax paid on the last dollar earned.

Nominal tax rate. The tax rate that appears in statute, applying to taxable income, assessed value, or sales. It can be distinguished from the effective tax rate, which is based on total income, the market value of property, and exemptions or the lack thereof.

Personal exemption. An amount that is subtracted on a per person basis in the calculation of taxable income.

Personal income. A broad measure of all the income received by residents of a state.

Progressive tax. A tax for which tax liability as a percentage of total income rises as income increases.

Proportional tax. A tax for which tax liability is a constant percentage of total income at all income levels.

Pyramiding. A tax on a tax. This occurs when one business pays a gross receipts tax (or sales tax) and then one of its customers pays the tax on the price made higher by virtue of the initial tax, with no allowance for the tax that has already been paid.

Regressive tax. A tax for which tax liability as a percentage of total income falls as income increases.

Severance tax. A tax on the removal of a mineral from the ground, such as oil, gas, coal, and gold.

Standard deduction. A fixed amount that is subtracted in the calculation of income subject to tax. Usually a taxpayer may elect to take either a standard deduction or itemized deductions, whichever is greater. Although different standard deduction levels usually are specified for single and joint returns (and often for heads of households), they are not otherwise adjusted for the number of persons in a household.

Taxable income. The measure of income to which tax rates are applied in calculating income tax liability. Taxable income is adjusted gross income minus deductions and personal exemptions.

Value added tax. A tax on all the sales of a business after subtracting its purchases from other firms.

Vertical equity. The idea that households with differing levels of economic well-being should be taxed differently, so that households with higher levels of income pay disproportionately more.

Vertical integration. The merger of a business and its supplier. It may be encouraged by a tax on purchases from suppliers because the tax can usually be avoided if the two companies merge.

This publication was prepared for NEA Research by

Steven D. Gold, Director
Center for the Study of the States
Nelson A. Rockefeller Institute of Government
State University of New York
Albany, New York

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NATIONAL EDUCATION ASSOCIATION
1201 Sixteenth Street, N.W.
Washington, D.C. 20036

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